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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 00/24

10:00 a.m., March 10, 2000

Contents

Executive Board Attendance

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

Executive Directors	Alternate Executive Directors
S.M. Al-Turki	A.S. Alosaimi
A. Barro Chambrier	D. Ondo Mañe
	B. Konan, Temporary
	J.A. Chelsky, Temporary
A. Carstens	H. Oyarzábal
R.F. Cippà	J. Schaad, Temporary
B. Esdar	W.D. Donecker
A.M. Jul	
R. Faini	H. Vittas
K.-T. Hetrakul	S.N. Kioa, Temporary
	A.G. Karunasena
W. Kiekens	
O.-P. Lehmussaari	
K. Lissakers	
J. Milleron	G. Bauche
A. Mirakhor	
J.P. de Morais	J.A.K. Muntali, Temporary
	A. Lushin
	L. Palei, Temporary
	S. Collins
	R. Junguito
A.S. Shaalan	
G.F. Taylor	
Wei Benhua	Jin Qi
	I.C. Ioannou, Temporary
Y. Yoshimura	H. Toyama

S.J. Anjaria, Secretary
A.S. Linde, Acting Secretary
P. Cirillo, Assistant
P. Kunzel, Assistant
G. Nkhata, Assistant

Also Present

IBRD: P. Levy, Latin America and Caribbean Regional Office. African Department: G. Devaux. Asia and Pacific Department: Y. Horiguchi, Director; R.M. Brooks, D.J. Robinson. European I Department: S.M. Thakur. External Relations Department: T. C. Dawson, Director; G. Hacche, Deputy Director; F. Baker, M.W. Bell, R. Chote. Fiscal Affairs Department: A. Cuevas. Legal Department: R.C. Baban, H. Elizalde, S.C. Ho. Monetary and Exchange Affairs Department: M.Y.J. Khamis. Policy Development and Review Department: J.T. Boorman, Director; T. Leddy, Deputy Director; L.J. Lipschitz, Deputy Director; B.B. Bakker, A. Banerji, N.R.F. Blancher, C. Brachet, J.P. Chauffour, C. Christofides, D. Desruelle, T.W. Dorsey, P. Gajdeczka, J. Hicklin, D.G. Jones, Y.A. Metzgen, P. Price, M. Rossi, R.E. Stern, R.C. Velloso. Research Department: M. Mussa, Economic Counsellor and Director; F. Larsen, Deputy Director; M.S. Kumar, M.A. Savastano. Secretary's Department: P. Gotur, B.A. Sarr. Statistics Department: K.G. Dublin. Treasurer's Department: A.B. Westphal. Western Hemisphere Department: M.E. Bonangelino, Deputy Director; T.M. Ter-Minassian, Deputy Director; M. Alier, B. Braumann, M.R. Figuerola, E.R. Jenkner, E.R.J. Kalter, G.A. Peraza, T.M. Reichmann, B.M. Traa. Office of the Managing Director: D.A. Citrin, J.A.P. Clément; Office of Budget and Planning: E.-A. Conrad, P.J. McPhillips, N. Sachdev; Office of Internal Audit: L. Alexander. Advisors to Executive Directors: J.A. Costa, S.S. Farid, O. Himani, J. Jonáš, Luo Y., W. Merz, H. Mori, A.R. Palmason, J.L. Pascual, G. Schlitzer, M.R. Shojaeddini, M. Sobel, S. Thiam, I.M. Woolford. Assistants to Executive Directors: S.A. Bakhache, J.G. Borpujari, P.A. Brukoff, R. Burgess, S. Çakir, M.J. Fernández, S. Hinata, A. Kapteijn, K. Kpetigo, D.H. Kranen, Liu Z., J. Mafararikwa, I. Mateos y Lago, J. Sigurgeirsson, R.J. Singh, Vongthieres O.

1. SURVEILLANCE OVER EXCHANGE RATE POLICIES—REVIEW

The Executive Directors considered a staff paper on the biennial review of the implementation of Fund surveillance and of the 1977 surveillance decision (SM/00/40, 2/18/00; and Sup. 1, 2/29/00).

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

> Much progress has been achieved since our review in March 1998 of the lessons for surveillance from the Asian crisis in which we identified a number of areas where Fund surveillance could be strengthened. Of note is the increased emphasis that has been placed on exchange rate regimes, financial sector vulnerabilities, capital account issues, debt and reserve management, as well as improved and more timely data provision to the Fund. The implementation of many improvements notwithstanding, however, the rapid pace of integration of world capital markets and the continued evolution and widespread use of information technology present ongoing challenges to the Fund's ability to perform its surveillance function optimally. Added to this are the conflicting demands from different quarters, on the one hand, for a widening of the surveillance agenda to areas that do not fall within the Fund's realm of competence or expertise, and, on the other, for a tightening of the Fund's budget. In our view, maximizing the effectiveness of the Fund's central role, namely crisis prevention and management, hinges to a great extent on our readiness to take decisive and strategic decisions on the scope of the Fund's work in the period ahead. This would entail:
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> a. focusing on core areas that are of direct relevance to macroeconomic assessment;
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> b. continuing to accord the highest importance to continuous bilateral surveillance and ensuring the availability of sufficient resources for this function; and
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> c. more effectively integrating multilateral and bilateral surveillance, including better integration of conclusions of policy papers into country work.
>
> Focusing on core areas
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> Despite the rapid evolution of the global financial system and the increased relevance to financial markets of areas that do not fall within the Fund's competence, in our view the core areas deserving in-depth attention in Fund surveillance continue to fall under the headings of exchange rate and external sector issues, monetary and fiscal issues including relevant standards and codes, broad financial sector issues including their linkages with capital flows, as well as cross-country policy comparisons, interdependence, and contagion. The post-Asian crisis period under review has seen important

progress in surveillance in all these areas. Most notably, analytical coverage of exchange rate policies has deepened; greater emphasis has been accorded to the analysis and strengthening of the broad financial sector and to minimizing the vulnerabilities emanating from capital flows. More attention has also been accorded to identifying potential spillover effects and contagion. This is an evolving process, however, and there will always be scope for continued improvement of surveillance in all these areas. Before turning to specific areas to which we would accord particular emphasis, we have two general remarks on the core/non-core debate.

First, the notion that runs through the paper before us, namely that non-core issues are, in fact, addressed in staff reports only if they are directly relevant to the macro situation, in our view, does not advance the strategic question of making a determination of what are core and non-core issues. In any case, even after making a determination that a non-core issue is relevant, it does not follow that the Fund should engage in its assessment. We would submit that, instead, the Fund should receive input on such non- core issues from other organizations with the appropriate competence.

Second, as a matter of principle, the Fund should not acquiesce to pressures from outside fora to venture into non-core areas. However well intentioned, outside demands on the Fund are generally made with little consideration of the Fund's staff expertise and budgetary constraints. This admonition is particularly relevant to non-accountable bodies or groupings.

Turning to specific issues, we note in particular, the staff's concern that the intensification of problems in the financial sector across a range of members and the increasing potential for spillover effects to the macroeconomy indicate the need for enhanced staff expertise in this area. Here, we would propose an even bolder suggestion than merely increasing staff resources in this area. We propose a serious review of the present situation whereby both the Fund and the Bank share responsibility for coverage of financial sector issues. While we do not doubt that cooperation between the two institutions has improved since the Asian crisis, it is also clear that a great deal of resources and staff time is spent on administrative aspects of coordination. In our view, there are considerable efficiency gains to be made in housing financial sector expertise solely within a single institution rather than continuing to rely on cooperation and coordination between the two bodies. We would submit that the Fund is the appropriate institution to undertake this task.

On capital account issues, we agree with the staff's conclusion that more attention should be accorded to analyzing members' capital account policy regimes and to the assessment of the influences of capital flows on the macroeconomy and financial and other sectors. We are hopeful that the Board discussion next July on this subject will shed valuable insight on the links between the capital account and the financial sector and that it will be possible to reach conclusions that could be integrated into the bilateral surveillance exercise. Important work has already been done in assessing the role of capital controls in specific circumstances of individual members and this should also be better integrated into our surveillance. While we welcome the more open-minded and nuanced view of the costs and benefits of capital account liberalization among staff, as evidenced by the reduced frequency of recommendations for swift liberalization, further work on the practical issues related to the pace and sequence of capital account and financial sector liberalization is needed.

On assessments of vulnerability, an ongoing refinement of appropriate vulnerability indicators is critical to the surveillance exercise. Already, important improvements have been made over the past two years. We see much value, in particular, in the special emphasis being placed on debt-based measures of the adequacy of reserves and indicators of the usability of reserves. Contrary to the views expressed by the external evaluators, however, we would caution against a more extensive use of EWS. These measures suffer from a number of shortcomings which argues against their public use.

The benefits of assessments of corporate sector vulnerability for crisis prevention have, of course, come to the fore with the Asian crisis. However, as staff note, in-depth corporate vulnerability assessment is both analytically difficult and resource-intensive. In any case, this is an area in which we should rely on the World Bank to the maximum extent possible, rather than try to develop in-house expertise.

According the highest importance to continuous bilateral surveillance

Our remarks here focus on two points, first, the importance of confidentiality to assure effective surveillance and, second, the need to allocate sufficient resources to this function which is central to the Fund's task of crisis prevention and management.

On the first point, we start from the premise that assessments of exchange rate policies of member countries are at the heart of Fund surveillance and every effort should be made to preserve their reliability. As noted by staff, since 1997 an increase in the candor of staff assessments and policy advice, for emerging market countries in particular, is evident. It is imperative that we do not in any way jeopardize this candor, which is essential for the Fund to effectively perform its central role of confidential advisor to its members. Of relevance here is staff's observation that the sensitivity and confidentiality which country authorities accord to exchange rate policy issues is reflected in the fact that only a minority of authorities chose to include a response to staff's exchange rate recommendations in Article IV reports. This points to the risks inherent in the possible publication of Article IV staff reports. We believe that publication is bound to erode the frankness of the discussions with the authorities. This, in turn, will inevitably, reflect adversely on the Fund's surveillance role, even if it is not immediately apparent.

Our second point relates to the importance of ensuring that the demands of surveillance are balanced with the availability of Fund resources. We are currently observing a serious imbalance in this respect, as evidenced by a diminishing of resources being accorded to bilateral surveillance. The need for more in-depth coverage of issues which legitimately fall in the Fund's domain is one reason for this. However, it must also be acknowledged, as already noted by the external evaluators, that a broadening of the Fund's surveillance agenda beyond core areas risks diluting its bilateral surveillance function and its coverage of core issues. In this context, we find it incumbent upon us to add our voice to those who are skeptical of the wisdom of the Fund's allocation of part of its limited resources to the assessment of policies aimed at poverty reduction. Staff resources are already overstretched and can barely do justice to an optimum coverage of core surveillance issues. Adding such non-core issues to the agenda only exacerbates the problem. We note with concern that resources allocated to bilateral surveillance and associated activities have fallen in the past two years, and that delays in consultations have risen and coverage of the membership has fallen since 1995-96.

More effectively integrating multilateral and bilateral surveillance

While multilateral surveillance has expanded and strengthened considerably over the past two years, significant value-added could potentially be gained from a more effective incorporation of the analysis underlying this work into Article IV consultations. While some progress has been achieved in this area, there is considerable room for improvements. We find that views expressed in reports like the WEO and Capital Markets Report do not sufficiently filter through to area departments. This points to the desirability of strengthening contacts and coordination between the departments involved in multilateral surveillance and area departments. Our feeling here is that staff constraints are the main hindrance to effective coordination. The same concerns apply to a variety of policy papers that are very relevant to the operational work of the Fund. These issues need to be squarely addressed if we want to render Fund surveillance more effective.

Mr. Wijnholds submitted the following statement:

Introduction

Since our discussion on the External Evaluation report, staff has reviewed (and rumor has it that this was over the Christmas holiday) 277 reports on exchange rate issues, 66 reports on financial sector issues, the capital account and vulnerability, and 138 reports on core/non-core. They will be relieved to know that I find their stock-taking invaluable. To my knowledge, the comprehensiveness of the analysis on coverage of staff reports is unprecedented. It serves to establish the common data set, on the basis of which the Board decides how to get from A to B. Put differently, staff has shown us how far A is from B, which should prevent us from getting lost, as we try to redraw the map of Fund surveillance.

The analysis was useful for me personally in two main respects. First, I was not fully aware of the large percentage of reports in which non-core areas are already covered and the Board had in fact mandated them to do so. For example, I was not aware that the Board, in providing guidance on poverty issues in 1990, had asked staff to raise with authorities issues such as infant mortality, illiteracy rates, life expectancy and school enrollment. In my view, these are all issues which are in the domain of the World Bank and should not be covered by staff. I also take note of the remark that these poverty issues are not usually linked to macroeconomic assessment. To me, this means that we may need to revisit some of our guidance notes on non-core issues. Conversely, I was somewhat surprised that core-areas are not covered in a large number of reports. I say 'large' because my benchmark for core-areas (the exchange rate, monetary, fiscal, current and capital account issues including trade liberalization, and financial sector issues) is 100 percent. A case in point is exchange rate issues. I cannot read the Articles and the guidance notes any other way than that there is a presumption that the exchange rate will be assessed, one way or the other, in every single report. Yet, an assessment of the regime, the exchange rate level, or the REER is made in only roughly half the staff reports. Similar remarks apply to the lack of vulnerability and cross country assessments.

Theory versus Practice

I could list a number of things which I believe should be central to Fund surveillance. To do so, however, would be futile given that I see all of them already included in the 1991, 1995 and 1997 staff guidance notes for surveillance. To give a few examples:

-"staff reports will focus on core areas of surveillance over exchange rate policies (..) staff should exercise judgment (...)selectivity rather than uniformity"[1991, 1995 and 1997 guidance note]

-"include candid assessment of the behavior of members' exchange rates and their exchange rate policies based on an evaluation of balance of payments developments, including the size and sustainability of capital flows, against the background of reserves and indebtedness" [1995 and 1997 guidance note]

-"will draw attention to cases where deficiencies in data quality and/or lack of timely reporting are hampering effective surveillance"[1995 and 1997 guidance note]

-"include assessment of problems and policies in the banking and financial sector where they are of macroeconomic significance (..) beyond coverage of core staff should take into account management guidance on the coverage of other issues (..) examine current and capital account measures (..) include cross-country comparisons where appropriate"[1997 guidance note]

So why do the evaluators and many Board members feel that these things are being done insufficiently (to at least some extent borne out by staff's report)? There are several possibilities. One explanation is that staff does not read the guidance notes. In the contacts that I have had with staff it was pointed out that this is in fact the case. A good example is perhaps our new policy on transparency where staff frequently seems to be completely unaware of Board policy, the procedures for issuing documents etc. Of course, one could argue that staff does not necessarily need to read the (many) guidance notes and Board summings up (for some issues there is no separate staff guidance note other than the summing up), as PDR will do it for them in the review process. Indeed, both briefing papers – setting out what will be covered in the consultation – and the papers themselves are sent to PDR for approval and, reportedly, frequently changed to comply with Board guidance. Another explanation could be that the Board is wrong in believing that some issues are covered too often and others not often enough. Yet another explanation is that the guidance notes themselves are not specific enough, too vague, and do not really provide any guidance at all.

I suspect all three explanations are part of the answer. The way to deal with this, in my view, is to think much harder than we perhaps have about the incentives which affect behavior in this institution.

Concrete proposals

Let me say up-front what I hope to get out of today's meeting and then explain why I believe these things are important.

Proposal 1: each staff report (including industrial countries) should, at a minimum, contain four tables: a balance of payments table, the budget, a monetary survey and a vulnerabilities table. This should be explicitly stated in the surveillance guidance note.

Proposal 2: the staff operational guidance note for surveillance needs to contain a guideline for a mandatory litmus test for including non-core issues (see below).

Proposal 3: all guidance notes and summings up should be consolidated into a single 'Surveillance Manual' readily available to both Area Department staff and the Board.

Proposal 4: the Board will be provided with a periodic report on the discussions that took place in the Surveillance Committee, in order to bring important differences of view on economic policies in countries to the attention of the Board.

Proposal 5: an additional channel will be created for staff – perhaps in the form of a 'vulnerability supplement' - to communicate confidential information about surveillance, with the up-front assurance that the information will be kept confidential and will not be published.

Proposal 6: distribution of staff papers for other fora. This has already been agreed upon, and I look forward in particular to receiving the future G7 surveillance papers, as has been agreed with the Secretary during the work program discussion. These, in particular, were deemed of a high quality by the external evaluators and could constitute a useful input to the Board's multilateral surveillance.

Proposal 7: each staff report for countries with access to capital markets will report the terms and maturity of borrowing, developments in secondary market spreads, possible rating developments, and possible market commentary that significantly deviates from staff's appraisal. This should be explicitly stated in the surveillance guidance note.

Proposal 8: surveillance missions should be scheduled less on the basis of staff schedules and more on the basis of the agenda of national policy debate. To maximize impact and influence, missions could be scheduled in the initial stages of budget preparation or immediately following an election.

Proposal 9: review our procedures for summings up of Board meetings. These are now often insufficiently reflective of the discussion, leading to a lack of internal transparency.

Proposal 1 ('basic tables') is a reaction to two things. First, industrial country reports sometimes do not contain more than a single table with 'basic indicators'. I have seen staff reports which did not contain a (detailed) balance of payments, overview of fiscal operations past the current year or a monetary survey even though this data has been readily available in, for instance, publications of the central bank or Ministry of Finance. The Board does not have time to track this down. Moreover, industrial country reports are, as far as the statistical tables are concerned, not as forward looking as developing countries or emerging markets (a medium term framework is often omitted). While I appreciate efforts at streamlining, this should in my view not pertain to eliminating everything but the most basic data. Proposal 1 is also a reaction to the still insufficient attention to vulnerability analysis. Heightened attention to vulnerabilities could be the single most important improvement to our surveillance, especially as, in a globalized world, all countries are vulnerable and systemic. While I am glad that vulnerability ratio's are increasingly discussed, the target should be to do this in all staff reports, without exception. If the data is unavailable, this should be noted. We could await the up-coming seminar on debt and reserve related indicators of vulnerability, to decide on the minimum list of indicators which would be covered in a vulnerability indicator list in every report.

Proposal 2 ('the macroeconomic relevance test') is meant to counter mission creep, increase selectivity and focus, and pressures to be the 'amazon.com' among IFI's. Concretely, the Board could accept staff's classification in the report of 'non-core' (i.e. labor market, social security reform, other structural, poverty, environment, military, governance). Then, if staff wants to devote a paragraph or heading to these non-core issues this needs to be "chapeau-ed" by an explanation of the macroeconomic relevance of doing so, and why it cannot be done by another IFI. The guidance note currently only dictates that staff should make that assessment itself. My suggestion is simply to make this assessment explicit in the report, which would inject discipline. Core issues would be expected to be covered in all reports. Non-economic issues would not be covered at all.

Proposal 3 ('surveillance manual') is an attempt to consolidate the overwhelming array of guidance notes and summings up into one document, and make this readily available to both the Board and staff. As I noted, I doubt whether anyone is fully aware of the guidelines of the Board that lie scattered around this institution. The guidance note for governance issues alone is 12 pages, while that for general surveillance issues and exchange rates is 14 pages, and there are numerous others on the financial sector, the environment, poverty issues, military expenditure, our transparency policies etc. A consolidated note could, for instance, be put on the Fund's internal website. Certainly a consolidation of all the guidance would provide scope for eliminating overlap, as evidenced by the partially repetitive nature of the successive surveillance guidance notes (which formally do not replace each other).

Proposal 4 ('surveillance committee reporting') is intended to involve the Board in difficult policy debates. One of the critiques in the External Evaluation reports was that the internal review process may, inadvertently, lead to bland reports. Partly, this may be due to the desire to present the Board with a common view. The Board, however, has clearly indicated that discussion could benefit from differences of view and issues for discussion about alternative policy options. The issues discussed in the Surveillance Committee could serve as a guide.

Proposal 5 ('vulnerability supplement') is intended to preserve the candor of staff vis-à-vis the Board. If bringing information to the Board becomes equivalent to providing information to the public, this will entail a net gain to the public (which gets more information than before) and a net loss to the Board (which, presumably, gets less). Anecdotal evidence, supported by the External Evaluation report, and informal contacts with staff make clear that pre-editing is widespread; we will come back to this in our evaluation of the pilot and transparency policies. Our current policy is that, in principle, virtually every document that comes to the Board will be published: LOI/MEFP, Selected Issues papers, policy papers, increasingly Article IV's, Rosc's. One of the main exceptions to this are the FSSA papers and it has been acknowledged that the candor of that exercise depends to a significant extent on confidentiality (indeed, we even had a debate that such papers should not be brought to the Board for this reason, which I opposed). Put simply, we have to provide staff with a channel through which they can communicate confidential information, with the ex ante assurance that it will not be published. My proposal would be to allow staff to publish a short 'vulnerability-supplement' with each Article IV report. This would help staff in that they do not have to carefully word the language of the staff report with possible danger of pre-editing; we thus avoid difficult discussions on deleting 'market sensitive' information. We could still maintain vulnerability indicators in staff reports (such as short-term debt/reserves) as these reflect available economic data (akin to Mr. Portugal's distinction of objective versus subjective information).

Proposal 6 ('papers other fora') is self-evident.

Proposal 7 ('use of market data/views') is becoming increasingly important as, for countries with fixed exchange or a dependency on private market borrowing, it matters not what the Fund believes to be the right assessment but what the market thinks. In this regard, I for instance welcome the quarterly Emerging Markets Financing Note prepared by the Research Department. Under this heading, I would also advocate making more use of other data sources, where Fund data is found wanting. Specifically, I continue to see that some staff reports do not cross-check debt data with BIS data. It may be true that some authorities have a resistance to anything but official statistics but creditor data has proven to be a much more reliable guide than debtor data in certain instances. Moreover, creditor data is more readily available and, as the BIS statistics are concerned, at least establish a lower bound for a country's (short-term) debt position.

Proposal 8 ('timing is everything when there's no money on the table') would also seem to be self-evident.

Proposal 9 ('internal transparency') would be important for three reasons. First, there have been a few recent instances in which, following assurances by the chairman to add something to the summing up, the Secretaries Department was pressured by an ED to leave it out. Market sensitivity, in this regard, does not apply to summings up, only to PINs. Second, if summings up do not reflect the Board discussion (particularly if there is a detailed intensive discussion on a certain topic) the subsequent Board discussion will not be able to feed on this. Third, a non-transparent summing up sends the wrong signal to country authorities.

Concluding remarks

If I were to summarize what I see as the main area in which surveillance can be strengthened it would be the lack of candor in talking about the truly important issues, from the standpoint of stability in the international monetary system. This is why I have focused on getting the right coverage in reports (core/non-core, vulnerabilities, market views, cross country focus) through creating incentives ('confidential vulnerability report, clearer guidance). It would be a mistake to think that the Fund will have long term added value if all we do is cater to a country's self-comfort. In the last meeting, I called this 'tough love'. Having said that, the countries remain our clients. Thus ultimately, the IMF exists because countries want to be helped, not because we force help on them. Being transparent may make ignoring advice more painful for country but it may also lead country to resist our help. The Fund is not your rating agency but your 'shrink' (and sometimes your bank-in bad times). The question is perhaps not: what can we do to help markets function better but rather: what can we do to become a better more effective shrink.

Extending Mr. Wijnholds's remarks, Mr. Kapteijn made the following statement:

I think it would be useful to highlight a few of the points from Mr. Wijnholds's statement. He puts forward nine very specific proposals to strengthen the way we do surveillance, and I want to state clearly that we realize that for many of these proposals, it is probably still too early to take a decision. I think, as Mr. Collins and Mr. Burgess note in their statement, we have key discussions coming up in the next few weeks and months, such as on the FSAP and the transparency policies, and we fully agree with that. It is not our intention to have everything implemented by next week.

What we would suggest is that we take up the suggestions made by Directors in a paper at the end of this year, after we have had all these discussions. The Board meeting at the end of the year could take up the Board guidance provided during the discussions. We could also take up the action plan as proposed by Mr. Bernes and Mr. Chelsky and also other Directors, and incorporate the Board views.

The proposals Mr. Wijnholds put forward in his statement were made on the assumption that they reflect common ground in the Board, and we hope that staff will revisit them. Many of them probably seem quite mundane, but we do think they could operationalize some of the views expressed in the statements. There are four I want to highlight.

The first was already highlighted by Mr. Shaalan: the macroeconomic relevance test. We already have this test in our surveillance guidance note, but in practice this means leaving it up to the staff that writes the report, and it has not always been clear to the Board what the underlying analysis was behind some issues being included and not being included. And so the only thing we ask, as Mr. Shaalan notes, is to spell it out in the report. We do not have to agree on what is core and noncore is; maybe we could agree on the "corest" of the core, which I think there is near consensus that balance of payments, monetary, fiscal, exchange rate, financial sector issues that those are issues where I think macroeconomic relevant would be obvious and staff would not have to go into any detail in explaining why they are covering all issues and explain why they are covering it.

The second proposal was to include a minimum set of statistical tables, namely the balance of payments, monetary survey, fiscal, and a list of vulnerability indicators in every single report. It may sound somewhat like stating the obvious, but the fact of the matter is that we have had a few reports which did not even contain a balance of payments. There have also been a few instances, particularly for industrial countries, where the tables do not look beyond the current year for many economic indicators. In our view, minimum statistical coverage expected in a report should be made part of surveillance guidance notes.

Third out of the four points that I want to highlight, is that we propose to consolidate the overwhelming amount of guidance notes and summings up into a compendium surveillance manual. We now have pages and pages of Board guidance on every single core issue you can think of, of course the routine surveillance issues, such as exchange rate assessments, financial sector assessment; as an example, the guidance note on governance issue alone is 12 pages long. And I originally had this vision that the staff would go to the country with this folder in which all these guidance notes are stapled together, but apparently this is not the case. We spoke to the staff extensively about this, and the bottom line is that staff basically do not read half the material that comes out of the Board and relies on Policy Development and Review Department in the review process. We think it would be useful to consolidate all these notes into a single document and streamline them, and perhaps put it on the web site at some stage for easy reference.

The last point which I want to highlight, which we address in the statement, is the issue of candor versus transparency. I think there is very broad recognition by now that there is tension between asking staff to cover the most sensitive issues and having a presumption that every single document that comes to the Board will be published. We are quite fearful that our transparency policy may rule out serious vulnerability analysis, and I think the recognition that transparency could affect candor was also evident in our discussion on FSSAs, where it was proposed not to bring these to the Board. So we deem it important to have a communication channel between staff and the Board for providing confidential information and specifically what we suggest is to have a separate vulnerability assessment along side the normal Article IV paper and this supplement would not be published. We agree with Mr. Collins, Mr. Burgess and others, however, that we can come back to this after we evaluate the pilot.

Mr. Bernes and Mr. Chelsky submitted the following statement:

The preparation of a report like the "Biennial Review of Surveillance" is no easy task. The challenges inherent in reviewing a massive volume of Fund documentation in an effort to extract lessons for improving Fund surveillance are daunting, particularly given that, for such a review to be meaningful, it must be grounded in a qualitative assessment of observations and policy advice. Objective, quantitative analysis, while providing an interesting perspective, is limited in the insight it can provide on how to make surveillance more effective. It does not help us address the fundamental question which such a review attempts to answer that being, "what did we do right and what went wrong in our surveillance".

The task is further complicated when we seek to simultaneously respond to the Board's discussion of the recommendations arising from the External Evaluation of Surveillance. In this regard, it is unfortunate that– as was promised in the Chairman's Summing Up from the Board discussion of the evaluation report –a separate report detailing management's program to deal with the issues raised by the External Evaluation has not been prepared. The Biennial Review makes a partial attempt to fill this gap but, as far as transparent and systematic follow up to the Evaluation goes, it falls short.

I therefore still see merit in the preparation by management of an action plan to respond to those issues raised in the surveillance evaluation that were endorsed by Directors. While I appreciate that much has already been done or is underway, the articulation of a clear response is important from the standpoint of accountability and the credibility of independent evaluation at the Fund. It will also be important given the Board's decision to have a stocktaking of follow-up to the surveillance evaluation after one year.

Chief among the issues that staff addresses in the Biennial Review is the appropriate scope of Fund surveillance. Here, they present the results of a quantitative assessment of the extent to which issues that are "core" and "non-core" to the Fund's mandate are discussed in Article IV surveillance. While such an exercise does contain useful information, I would be careful not to overstate its meaningfulness since what matters ultimately is what we say about a topic, not that the topic itself is mentioned.

A more informative approach would be to focus on the extent to which issues raised in staff reports are clearly and explicitly related to the macroeconomic environment and macroeconomic policy. What we need to avoid is gratuitous coverage of issues – whether they are "core" or "non-core". Staff has it right when they assert that the litmus test for inclusion of an issue in Fund surveillance is its macroeconomic relevance. In this regard, issues like the environment, military spending, governance, income distribution and spending on education and health care can be of central importance to the macroeconomic prospects of a member. For example, no analysis of Burma's economy would be complete without substantive discussion of military spending and the impact it has on fiscal policy and the balance of payments; no discussion of Uzbekistan's medium-term balance of payments prospects would be complete without addressing the environmental degradation associated with cotton production, one of the country's main exports; and no discussion of European economic prospects would be complete without a strong focus on labor-market issues, given the importance of internal flexibility under a currency union.

This leads me to believe that there are limits to the value of approaching surveillance in a manner that seeks to differentiate between "core" and "non-core" issues. As I have said before, issues that should be core to Fund surveillance are those that have the greatest relevance to a member's macroeconomic situation and policy prospects. Here, we should not expend too much effort in articulating a priori what is "core" and what is not. To do so would – as it has repeatedly in the past – leave us with a false sense of confidence about the scope for economic vulnerability and constraints to sustained and sustainable growth. Thirty years ago, we did not consider that the composition of public spending was a "core" concern for the Fund. We learned that this was not the case. Ten years ago, it was not widely accepted within the Fund that poor governance and corruption were legitimate targets for Fund surveillance. Cases of misreporting, large-scale theft of public resources and serious distortions in the allocation of resources showed us that we were wrong. The Asia crisis showed us that the financial sector – which we did not previously consider to be a core consideration for the Fund – was a major source of potential economic vulnerability.

Where we go start to go astray is when we exaggerate the extent to which we are besieged with pressures to "expand" the Fund's surveillance agenda. I agree that there is some validity to this concern but not nearly to the degree one might think based on some discussions we have had at the Fund. Rather, I would argue that experience and theory have shown us that many of the alleged "non-core" areas can, and frequently are, central to the macroeconomy. What this implies is that – if our policy advice is to be of practical value to our members – then a broad range of considerations will be relevant to our mandate. To a significant degree, pressures to "expand" the scope of Fund surveillance are about doing our job better, not about doing more jobs. I do, however, accept that the human resources required to do our job "better" are not negligible.

We should also be careful not to fall into the trap of defining as "non-core", issues for which we currently lack adequate expertise. To do so would let the "tail wag the dog". Rather, if a particular issue proves to be consistently important to macroeconomic developments and policy, it is an issue for which we need to improve our understanding.

Admittedly, there are cases where the Fund has been asked to integrate into surveillance concerns that are not clearly linked to its macroeconomic mandate and we must endeavor to minimize such occurrences. But we must also guard against a mechanistic or "grocery list" approach to the scope of surveillance. Common sense should be our guide here and it can tell us that what matters for Fund surveillance is what matters for the macroeconomy. Many at the Fund understand this and have responded accordingly by taking a more flexible approach to surveillance. A few stragglers however, continue to use this hierarchy of "core" and "non-core" issues as a substitute for common sense. Such an approach will not help us prevent crises that don't simply replicate past experience. This is not to say that Fund staff needs to be experts in all areas but that they should have an adequate awareness and understanding of issues beyond the so-called "core" considerations and an openness to learning about new areas. The importance of drawing on the expertise and resources of other institutions, including the World Bank, is key here.

One implication of this is that the human resource issues pertaining to Fund surveillance in the 21st century are not only about how many staff we have, but also how well equipped staff is to deal with macroeconomic policy in a multi-dimensional setting. The external evaluators raised this issue when they argued that the hiring of EPs should put greater emphasis on practical experience with policy making rather than academic qualifications alone. Someone who has actually seen the day-to-day workings of government or a central bank is, for example, much more likely to understand that governance considerations are inseparable from effective macroeconomic management.

I would, however, depart in one sense from the principle that surveillance should consider as core whatever has a significant impact on a member's economy. As staff and the external evaluators rightly note, it is important that bilateral surveillance identify policies of members that may be harmful to the macroeconomy of other members, even though such policies may have a negligible impact on the member initiating the action. The obvious candidates here are issues like the impact of high interest rates in large economies on other countries. To this, I would add, industrial country barriers to trade in textiles and agricultural goods from developing countries, public facilitation of exports of military goods to low-income countries, the absence of a legal framework that dissuades bribery of foreign officials, and banking laws that permit excessive levels of secrecy.

Among the issues raised by the evaluators was Board ownership of the surveillance process. I would have liked to see greater attention devoted to this topic in the Biennial Review. There have been innovations made to enhance ownership since the external evaluation and they are worth mentioning. At the same time, there is room for improvement and this too should be noted. On this point, I look forward to the adoption – for a trial period – of new procedures for Article IV discussions immediately following the Spring IMFC Meeting.

Turning to specific issues in surveillance, I was particularly interested in paragraph 33 in the staff report. Here, staff indicates that their policy advice on exchange rate regimes has become more candid but that concerns with sensitivity and confidentiality had prevented staff from discussing their dialogue with the authorities in the staff reports themselves. I appreciate staff's frankness here. At the same time, I believe there is scope to provide Directors with a larger window into these deliberations. The sentence "the exchange rate regime has served the authorities well and remains appropriate" appears frequently in staff reports but it is too frequently accompanied by very little explanation or justification. I would hope that – at least in the Board discussion – where such an assertion is likely to be questioned, staff can be more forthcoming.

In paragraph 38, staff note that inadequacy of information on the financial sector is not, at present, given much attention in staff reports and they advocate that data gaps – and the reasons for them -- be routinely identified. This recommendation deserves our full endorsement. On data more generally, I would welcome a more informative discussion of the limitations of the official figures, as well as the seriousness of the implications for surveillance. At present, staff reports make only modest differentiation among members with data problems, regardless of the severity of the problem. For the most part, this takes the form of a sentence or short paragraph almost always at the end of a staff report and the Summing Up indicating that data is "unsatisfactory" or has "shortcomings". Where problems are particularly egregious, we should give the issue a higher profile throughout the document. An upfront admission when we are not confident of the accuracy of our economic assessment because of informational constraints would, I believe, improve the information content of surveillance more generally.

Still on data, and as part of an ongoing effort to improve the quality of Fund surveillance, I was pleased that staff is providing more extensive coverage of capital account data. At the same time, and as I have argued previously, the Fund needs to be aggressively undertaking work on the conceptual underpinnings of capital flow measurement and the impact that derivatives and other financial innovations have on the meaningfulness of traditional measures.

Turning to the discussion of output gaps and Fund surveillance, I did not find the analysis presented convincing. Rather, it raised more questions than it answered and therefore probably deserves further study by staff. One question that did occur to me was the extent to which the meaningfulness of the gap analysis is eroded in a highly open small or medium-sized economy. This point was raised in the context of the Netherlands Article IV discussion where a small or non-existent output gap generated consistently unmet expectations of inflation. On the more general question of an alleged contractionary bias in Fund advice, I also think we need to look at countries in crises separately. Here, we must wrestle with allegations of a systemic bias toward underestimating the contractionary impact of the crises.

I was pleased to note the increased provision of information on the views of private-sector forecasters in Fund surveillance. Here, I would make one request. Staff frequently compares their outlook to that of a consensus of private-sector forecasters. What is not routinely reported is the period over which the forecasts contained in the consensus have been produced. This is valuable information since there are times when a significant development can seriously shorten the "shelf life" of even the most reputable forecast. That fact that consensus forecasts often make use of individual forecasts produced over a period of many months is therefore a key consideration in relating staff forecasts to those of the private-sector consensus.

Finally, I would have welcomed a systematic review of how alternative scenarios are used in Fund surveillance. My understanding is that the choice of an alternative scenario is left entirely up to the mission chief and that no formal guidelines exist to influence the nature of that scenario. Particularly at a time when we are increasing our emphasis on "vulnerability indicators", consideration should be given to a more structured approach to alternative scenarios.

To close, and to put what I have said in perspective, it should be acknowledged that staff surveillance is widely regarded as being of exceptionally high quality. This is an assessment with which we agree. However, we at the Fund – staff, management and Directors – must never become static in our approach to surveillance or in the factors which we are willing to consider as relevant to macroeconomic prospects. We must be constantly questioning to ensure that we remain in a position to provide our membership with the best possible policy advice, both for the crises it will help us avoid and also for broad-based prosperity it will engender.

Mr. Kelkar submitted the following statement:

We wish to compliment the staff for providing an exceedingly useful and comprehensive review on a subject of "core" importance viz. the surveillance function of the Fund. The Fund is facing a rapidly changing environment which inevitably throws up new demands and challenges and the continued relevance of the Fund is critically contingent on its adaptability to the evolving milieu. Under the circumstances and especially in the context of the ongoing debate on the new international financial architecture, this biennial review has assumed a special significance. Even as an "interim report card", this much needed review – embellished with useful boxes and appendices, can go a long way in our collective introspection.

Our comments on the review has been organized in terms of overall remarks and specific observations on the issues for discussion (p.63-64), in that order.

General Remarks

While reading the review, one repeatedly gets an impression that the staff is being over-ambitious in trying to achieve two much. At one level, it is a regular biennial review; at another, the review is seeking an operationally meaningful revision of the 1977 Surveillance Decision. At yet another level, the review is also offering a constructive response the Report of External Evaluators on Fund Surveillance. This has created a familiar "too many objectives – too few instruments" kind of situation leading at times to lesser internal cohesion in the review than what one has come to expect from the Fund staff.

The review draws extensively on the Article IV consultation reports – as it should. However, while analyzing coverage (or lack thereof), in respect of a whole range of "core" and "non-core" issues, the review follows a simple "headcount" approach, focussed on identifying the proportion of Article IV reports where those issues are addressed (Tables 1 through 8). Needless to say that such "quantitative" analyzes are necessary, but not sufficient. Indeed, unless complemented by relevant "qualitative" assessments, they do not convey much. Moreover, there is some risk of defensive rationalization when those who are entrusted with the responsibility of surveillance are relied upon for self-assessment as we, in our view, given the crucial role of Surveillance in the working of the Fund especially need for a systematic external review process. In fact, the Report of External Evaluators on Fund Surveillance which was an one-off Report did make such a recommendation (para 106, p. 119 of that Report). Our chair would like to see some action on that front.

Core and Non-Core Issues in Surveillance

Within the limitations of an headcount approach, we agree that the staff are exercising selectivity in the coverage of non-core areas, and to that extent, we agree that Fund surveillance as it is conducted and as it is evolving responds to the Board's reactions to the Report of External Evaluators on Surveillance.

The staff have raised three issues in this regard which merit attention: external forces pushing an expanding surveillance agenda, concerns regarding even-handedness of treatment across the membership and the relevance of the "macroeconomic relevance" criterion in determining selectivity in coverage.

The reference to external forces pushing an expanding surveillance agenda raises the question of the role of the Executive Board vis-à-vis the staff. We would like to emphasize that the extent to which the Fund should respond to such external pressures must be decided by the collective discretion of the Board under the guidance from the Board of Governors.

Given the heterogeneity among the member countries as regards their stage of development, what constitutes a core issue may differ from country to country. The real issue therefore, is not what uniformly should constitute core areas for all countries irrespective of their stage of development but rather, what could qualify as core areas, specifically, for a given country at a given point of time. In our view, the surveillance efforts of the Fund should normally be confined to the generally agreed core areas uniformly across the member countries – such core areas have already been identified as exchange rate policies, balance of payments, financial sector and cross-country issues. Beyond these core areas, surveillance efforts could be extended to the so called "non-core" areas, only eclectically and with a minimalist approach. Such a middle path based on a two tier approach would balance the consideration of uniformity of treatment with the need for focus and saving of resources.

In a general equilibrium sense, a very large set of factors would qualify the "macroeconomic relevance" criterion and as such, further rationing would be needed keeping in view the Fund's comparative advantage and overall manageability. Accordingly, in our view, the "macroeconomic relevance" criterion would have to be refined further by directness of the underlying relevance and possibly by adding a time dimension. Thus, "non-core" areas could be covered only if they are deemed to be directly relevant to the evaluation of core areas under surveillance.

Exchange Rate Policies

We agree with the contention of the review that the assessment of exchange rate policies has been strengthened in Article IV consultation reports since 1997. It is comforting to note that in 1999 about 80 per cent staff reports of developing countries and 90 per cent staff reports of the emerging market economies contained a discussion of the exchange rate cast in the over all macroeconomic policy context and/or an evaluation of developments in the members' balance of payments. It is not clear, however why the REER based analyzes in respect of developing countries actually went down from 48 per cent to 40 per cent of the staff reports analyzed (Table 1, p.19). Staff comments would be appreciated.

Capital Account Issues

Our chair has consistently maintained that issues relating to capital account liberalization should be confined to appropriate pre-conditions and sequencing given the unsettled views on the costs and benefits of liberalization. We feel assured that this has been explicitly recognized in the review (para 43, p.29) and that in less than one-third staff reports which discussed this issue, the staff generally supported a gradual and sequenced approach (para 42, p. 28).

As indicated in para 40 (p.28) and Table 4 (p.28), aspects of external capital flows were discussed in a majority of staff reports for emerging market, transition and developing countries. Yet, issues relating to stability and sustainability as well as macroeconomic consequence of capital flows were discussed in only about half the number of reports. The staff comments on this undesirable selectivity are welcome.

We agree with the staff view that provision of important information on the usability of reserves and short-term debt would be useful for effective diagnosis of potential crises.

Cross-Country Themes

We welcome the extended coverage of cross-country themes such as, cross country comparisons, spillover effects and the key policy messages from multilateral surveillance in Article IV consultation reports of emerging market, transition and industrial countries. Since the Fund has an unmatched comparative advantage in this area, it can play a key role in developing and disseminating knowledge on cross country and regional issues. Examples provided in Box 9 (p.34) demonstrate the creative potential that can be brought to the treatment of cross-country issues.

Multilateral Surveillance

Our chair welcomes the Fund's expanded effort in multilateral surveillance since the last biennial review, as documented in para 52 (p.35). As to the earlier period, i.e., before the onset of the Asian financial crisis, however, we are inclined to share the "overall impression" of the External Evaluators that while the WEO and ICM reports "were helpful in understanding subsequent developments in Asia and elsewhere, the risks were not forcefully presented".

We believe that the effectiveness and impact of multilateral surveillance could be significantly enhanced if the ongoing work done by the World Trade Organization (WTO) is taken on board by the WEO. In particular, trends and issues in the global trading system – especially the incidence of protectionism by industrial countries needs to be spelt out in WEO as a regular feature. In this regard, the staff should explore the possibilities of incorporating inputs from the WTO's Trade Policy Review into the framework of multilateral surveillance.

Resource Constraints

We note drop in total staff resources devoted to bilateral surveillance between 1996 and 1999 and a contemporaneous shift in resources towards program cases. In our view, the additional resources needed for the new activities such as early warning, crisis prevention and various initiatives on standards, codes and data should be obtained through a sharper focus for surveillance and thus not expending resources on the indiscriminate extension of the Article IV surveillance to the "non-core" areas.

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

Overview and Introduction

Globalization and the increasing reliance of emerging markets and developing countries on private capital markets have the potential to dramatically improve the lives of people across a wide swath of the membership. But as the global financial turbulence of recent years has shown, these phenomena also pose new challenges for the international financial system. An important question that confronts the Fund is how all of our work can better position countries to harness the benefits of globalization, to work better with private markets and to promote a more stable flow of capital, while minimizing potential disruptions.

Surveillance is clearly an integral bread-and-butter part of that work. Building on last summer's External Evaluation, the Biennial Report highlights the progress being made in adapting surveillance to new global realities, but that much work remains to be done. Hence, the Review should be seen as an interim report, affording us the opportunity to take stock of the direction in which the IMF is headed and to assess the need for course corrections.

The staff is to be commended for systematically setting forth criteria by which to assess the various aspects of surveillance under discussion. But the tenor of the report on balance is too sanguine, and the analysis underlying certain parts should be revisited.

Cross-Country Themes

The External Evaluators rightly observed that the Fund's comparative advantage lies in bringing international experience and considerations to bear on domestic policy, a theme echoed by staff in the Review. But the Evaluators also wisely noted that the cross-country themes could be a starting point for Article IV consultations. Progress in looking at cross-country issues has been mixed, as suggested by Table 5. But equally important, it is rare that a focus on cross-country issues or external vulnerabilities is the point of departure for bilateral surveillance. Yet, such an approach is increasingly needed now when cross-country influences such as capital flows and risk pricing can swamp trade links. Even assessments of policies and prospects in the United States should take into account not only the ramifications of events at home for the world economy, but also the feedback effects of the world economy on the United States. Our multilateral surveillance remains farther ahead in addressing these realities than our bilateral surveillance.

Vulnerability Analysis and Surveillance

Against this background, vulnerability analysis, especially with a view to strengthening national balance sheets, takes on added importance. We appreciate that there has been considerable progress in including conventional "Indicators of External Vulnerability" in Article IV papers, especially for key emerging markets. Further, we commend EU1 for its treatment of vulnerability indicators, both for prominently highlighting these indicators and for often presenting many of them in a cross-country perspective. A recent Selected Issues paper for Croatia's Article IV, examining a truncated list of solvency and liquidity indicators for East European countries, merits praise as the type of work we would like to see from every area department, albeit with expanded treatment of the indicators. Interestingly enough, many express concerns that IMF publication of such information could unsettle markets, yet the Croatian Selected Issues piece was put on-line with the authorities' consent; it provided useful information to markets; and the markets didn't skip a beat.

But Table 7 & 8 highlight that there is substantial scope for progress. The treatment of vulnerability indicators could be more systematic throughout the Fund. There is substantial scope for more thorough cross-country comparisons within area departments, let alone across the membership. Does each area department keep a centralized database of vulnerability indicators for relevant countries? Further, in assessing national balance sheets, data refinements may be needed to improve vulnerability indicators – short-term debt ratios generally are presented on an original maturity basis, whereas residual maturity would be more useful; external debt data could emphasize more heavily residency-based data; data on the currency composition of debt could be usefully strengthened. Article IVs should also strengthen the coverage of public debt management practices. We look forward to discussing these issues and others at the upcoming Board meeting of "Debt and Reserve Related Indicators of External Vulnerability."

Financial Sector Surveillance

If there is one vivid lesson of the 1990s, it is that financial sector weaknesses can lead to highly disruptive macroeconomic consequences. Hence, Table 3 underscores that there is significant room to strengthen our focus on including indicators of financial system soundness. Of course, we appreciate that there is a need for more work in improving the quality and comparability of financial sector data, but that cannot be a reason to exclude such data on a more systematic basis. We look forward to the urgently needed work on Macro-Prudential Indicators. In short, with better vulnerability indicators, both conventional indicators and MPIs, the Fund could strengthen its surveillance and promote a more fully integrated assessment of countries' liquidity and balance sheets.

That said, staff – especially MAE – deserve praise for their intensified efforts on financial sector issues, which have rightly become more central to surveillance. Table 2 highlights this progress. We welcome the development of FSAPs and FSSAs, find the FSSA content to be of high quality, and look forward to the end-March review of FSAPs and the publication of FSSAs. The Biennial Report offers useful suggestions on how financial sector surveillance can be strengthened. We agree that staff could usefully formulate a clearer view on the benefits of timely and sound bank privatization. Article IV papers should highlight gaps in financial information, and pay more attention to countries' observance of Basel Core Principles, including focussing on Anti-Money Laundering frameworks.

Capital Account Issues

While progress is being made in analyzing capital flows, there is an ongoing need to better integrate capital market analysis into bilateral surveillance. Article IV papers still are biased toward passively viewing the capital account as reflecting the mirror image of current account developments, when capital flows may be driving the current account. We continue to believe the Fund should employ more experts with capital market background and feed their analyses into bilateral surveillance. The Fund needs to become more acquainted with capital market developments and private sector thinking; this point underlies our support for the IMF to establish a group to proffer views and advise on conditions in international capital markets. We share staff's view that considerable uncertainty remains about the international community's views on capital controls and the sequencing of their elimination and that greater staff discussions of this topic in Article IV reports could eventually prove beneficial in facilitating a consensus.

Surveillance over Exchange Rates

The staff's assessment of surveillance over exchange rate policies in transition and emerging market countries is too sanguine. The recent crises clearly underscored the incompatibility of maintaining a fixed exchange rate and discretion over monetary policy. The Board paper on exchange rate regimes highlighted that in view of the "trinity" argument, emerging markets should move toward floating or more highly constrained regimes. A recent EU1 paper on exchange rate regimes in selected advanced transition economies also reflected this view. The staff has also stressed that Inflation Targeting requires a relatively free-floating regime.

We believe Article IV reports have a way to go in underscoring the risks associated with maintaining relatively fixed exchange rates and monetary policy discretion. Members of the Fund, of course, have the right to choose their own regime, and there clearly is no one-size-fits-all approach. But Fund policy advice should move more forcefully beyond an approach in which the authorities' regime choice is taken as a given, and macroeconomic policies and prospects are examined in light of their consistency with that regime choice.

Exchange rate regimes in and of themselves can create risks that can affect stability. A fixed regime may lend itself more easily than floating to the build-up of unhedged foreign currency liabilities and national balance sheets, give rise to both borrower and creditor perceptions of implicit guarantees, and impede development of hedging instruments. Inconsistencies in countries' exchange rate views should be highlighted. In a recent report, staff backed a country's regime choice provided that fundamentals were strengthened. But staff did not comment that the authorities' desire to allow some exchange rate flexibility, maintain current rate levels to avoid currency related and balance sheet risks, and preserve stability against a regional currency constituted a potentially inconsistent set of objectives. In other cases in which staff advocated that currencies align with the Euro, there was little discussion of the implications of higher medium-term productivity growth relative to the Euro-area for macroeconomic performance and the regime choice. Further, staff analyses rely on REER analysis as a key means of assessing exchange rate levels. But emerging markets and transition economies are the very countries where deviations between CPI and other price-based measures of REERs tend to be the greatest and the most difficult to gauge.

Output Gap Analysis

The discussion of output gap analysis is a weak spot in the Review. It is unsurprising that when significant output gaps exist, staff does not recommend monetary tightening. But formulations of policy advice generally involve more subtleties. Monetary policy is forward looking – one speaks of tendencies and biases; one anticipates the future based on unreliable models, growth projections, and eclectic indicators. Fiscal policy is often set in a medium-term context and not easily fine-tuned given institutional realities and lags. Measuring potential growth is an art, not a science, and changes in potential growth are known well after the fact.

Since the mid-1990s, several European countries, the United States and Canada have achieved strong growth in the context of fiscal consolidation, lower interest rates, and (more) flexibility of factor markets. The interaction of these policies appeared to alter underlying relationships between growth, productivity and inflation. While central banks discerned that something might be afoot and attempted to grapple with it, one has the impression that our multilateral surveillance was more inclined to dismiss the possibility that underlying relationships might be changing. While there is a plausible case for this conclusion, in the end the Fund may have overestimated price pressures and recommended policies that, if followed, would have choked off quite a bit of growth at a time of weak global demand.

The Fund is also perceived as biased toward having offered restrictive advice on Japan. There can be little doubt about the sign of Japan's output gap. But staff supported a major fiscal consolidation in Japan in 1997 arguing that confidence effects would largely offset drag; this consolidation in hindsight is widely seen as having taken the legs out of fledgling recovery. Even last summer, staff felt Japan was heading toward an "upturn," but recent data have dashed that expectation. Yet, in light of the hope for a sustained upturn, the need for fiscal stimulus and monetary accommodation has been perhaps underestimated. For instance, last summer, staff endorsed sterilized Japanese exchange intervention, a policy staff now views as too restrictive.

Some of these errors might have been avoided if our surveillance had a stronger focus on rebalancing global demand.

Core/Non-Core

The focus of Fund surveillance was a central topic of the External Evaluation and of the Biennial Report. Clearly, all of us agree that the Fund must adhere to its mandate, be selective in its coverage of topics, and focus on issues of macroeconomic relevance. Yet, we must be mindful that the concept of "core" activities is not static. The Asia crisis highlighted, for example, that weaknesses in microeconomic underpinnings could have profound macroeconomic implications. Hence, in contrast with only five years ago, financial sector stability issues are now seen as a "core" activity of the IMF.

The experience of the last decades shows that many facets of policy are central to promoting sound growth. Governance was an issue touched on only lightly until recent years, yet governance and the establishment of the rule of law are a key for successful macroeconomic management. Many European Article IV papers focus on labor market reforms as these are desperately needed to unleash economic dynamism and rebalance global demand. Social security reforms critically influence fiscal policies and savings and investment imbalances. Enhancing rates of return on health and education spending is central to poverty reduction and spurring sustained activity.

As the Managing Director happily observed wherever he peripatetically globetrotted, one of the Fund's missions was to promote "high-quality" growth. While "macroeconomic relevance" should be a priority for Fund surveillance, the concept of "core" versus "non-core" activities can at times become blurred and confining.

Operational Aspects of Surveillance

With respect to operational aspects of surveillance, our chair would reemphasize the need to economize on Article IV staff resources. We need to think about streamlined missions, more succinct Selected Issues papers and avoidance of lengthy REDs, more continuous surveillance with remote fact finding, more reliance on bicyclic procedures, and more consideration of surveillance papers on a lapse-of-time basis. At the same time, we urge staff to broaden its consultations to engage other segments of society. The External Evaluators put forth many recommendations along these lines. The Africa Department just announced a reorganization that seems to move in this direction. Can we expect similar changes in other departments? Finally, we strongly urge Management and the Secretary's Department to work with area departments to time Article IV missions so that the Board will be able to play a part in the critical surveillance function thoughtfully and effectively. The current scheduling treats the Board as an afterthought.

Mr. Oyarzabal submitted the following statement:

Surveillance activities for the period 1997-1999 indicate that progress has been made in part as lessons have come forward from the Asian crisis. This experience has helped to strengthen surveillance in areas that have warranted deeper analysis and evaluation. In this respect, the emphasis on the exchange rate regimes, liberalization of the capital account, financial sector, and cross-country influences have become more relevant in that process. The strengthening of surveillance must run parallel to the strengthening of institutional capacity, particularly in emerging market countries, where this factor alone can mean the difference for successful policy implementation. As the international financial markets integrate in a more profound and increasingly rapid form, and Fund's surveillance should become more responsive to that reality. It must also address the challenges faced from issues that have a more medium or longer term solution. For the Fund itself, demands to widen the scope of the surveillance effort contrasting with the support that should be forthcoming in the budget, raises more questions as to how the overall process can be carried out without affecting the achievements already attained.

Looking back to the discussion on the external evaluation of surveillance, one would have welcomed not only an evaluation of the past, but also a forward looking approach that would have dealt with many of the issues raised by external evaluators which were also supported by directors during the Board discussion. It would be appreciated if in the near future a program that would further address the orientation of surveillance in this context were made available. The discussion today could be the first step in that direction.

I can appreciate the quantitative elements presented in the report, exemplifying the percentages of staff reports, which have analyzed the different subjects included in surveillance. This is a useful basic tool in that it relates to the proportion that specific issues in the surveillance process of a member country have been addressed in those initiatives. Still, of much more relevance for the purpose of evaluation would have been the significance, implications, and effects of meaningful and substantive analysis in dealing with the major issues of macroeconomic management. Another matter of concern is the fact that one would have expected that central issues that the Fund must deal with, basically exchange rate regimes and policies, fiscal accounts, balance of payments, monetary policy, and financial sector would have been addressed in all of the reports, which was not the case and certainly came as a surprise.

In the very delicate issue of defining the "core" competencies of the institution, great care must be taken. Fund members are heterogeneous, they are in different stages of development, have different capacities to respond to the challenges facing them, and some have very valid structural problems which must be addressed if they are of significant relevance to policy making in the macroeconomic area. These criteria would also need to be taken into account when considering the elements of spillover on a regional basis. As stated before, the development of institutional capacity in emerging and transition economies can be one of the subjects that must be addressed in this context. In this respect, just as important could be the domestic awareness of the role of the Fund, the breath and depth of domestic financial markets and the role of technology. One cannot expect the Fund to have expertise in all of these areas, but the utilization of experts from other multilateral organizations or, for that matter, their employment under a contractual basis would help in focusing with more clarity and generate awareness that would conclude on the possibility and velocity of a member country to analyze, decide, implement, evaluate, and correct policy decisions leading to more stable and sustainable economic conditions. This also translates on the need to address subjects or issues, which might not necessarily be considered part of the central mandate of the institution.

On a more specific note, the significant role played by the financial sector and its spillover effects are important enough to warrant the emphasis that has been allotted to this sector in the surveillance activities of the past two years. The particular needs for macroeconomic management would also help to sustain the view that the Fund should develop or strengthen its own analytical expertise in the area of the financial sector, with the particular nuance of this institution; despite its links with other organizations such as the World Bank and the BIS, enhanced Fund capacity can still play a role.

The Fund should maintain the emphasis on the capital account, greater description of the capital account policy regime and an assessment of the influences of capital flows on the macroeconomy on the financial and other sectors, as proposed by the staff, would be most welcome. The issue of gaps in information that have constrained the analysis of capital flows and the financial sector should be addressed as a priority.

The inadequacy of information should be given greater attention. It might be useful to address this subject explicitly at some later date, as it has wide implications not only for the surveillance process but, much more importantly, for the policy decision-making process. Recognition of this problem and its causes can mean a great deal in dealing with any of the major subjects that must be addressed by the institution and domestically for economic assessment.

Vulnerability analysis can be a useful tool in surveillance. The availability of indicators and their coverage are a welcome step forward. The possibility of strengthening early-warning capacity through vulnerability assessment, and the use of an early warning system (EWS) can be beneficial, yet great care must be given in utilizing such mechanisms. On the one hand, they might be given too much emphasis or importance without having established a track record, thus their implementation would be recommended on a gradual basis that would help determine their effectiveness and credibility; and, on the other, the use of such models requires high quality, timely available data, as well as sophisticated statistics which might be a constraint for many member countries to adopt such mechanisms.

The possibility of developing internal analysis of corporate sector vulnerability, which might be critical to crisis prevention, must be looked at very thoroughly. If corporate sector vulnerability can be identified and evaluated through the analysis of the financial sector, or current account, or capital flows, or external indebtedness, one would be more inclined to keep some distance from getting involved in this type of analysis, basically because it tends to be more micro-oriented and would require expertise that is not readily available in the Fund. It might be asking too much of the institution to go in this direction; yet, before taking a final position on the subject, it might be worthwhile to hear from the staff different alternative approaches that can be applied to identifying and evaluating corporate sector vulnerability.

As it has been stated before, the issue of the publication of Article IV consultations should be maintained on a voluntary basis. The essence of the relationship between the Fund and its members should be based on trust. The candor and frankness with which discussion of sensitive issues can be addressed between the staff and country authorities must confront the need for confidentiality. The possibility to advise and influence is directly proportional to the mutual trust between the parties involved in such a process. This essential characteristic could be at the core of creating ownership in policy-decision making based on comments, suggestions, constructive criticism, or analysis of alternatives coming from an external, non-domestic source.

Staff signals out that the effectiveness of surveillance for exchange rate policy depends on three factors which, effectively, can be applied to the surveillance activity in general: (a) "The existence of timely and clear advice on ....; (b) "The candor of the assessment ....; and, (c) "The views of the authorities and their willingness...." Independent of these three factors, if there is no mutual trust ownership is not motivated and created. The surveillance process can be a means of helping a member country strengthen its macroeconomic fundamentals, diminish vulnerabilities, and avoid crisis situations.

Multilateral surveillance, as carried out in the WEO, the ICM report, and the WEMD sections, have been very useful, yet it is not totally clear as to how their content has been translated into an input for policy discussions in member countries. There is a gap here, which might warrant further internal analysis and discussion, so that these instruments can be of more relevance to member countries.

Finally, care must be taken to allocate adequate resources to address the strengthening of surveillance. The Fund's human resources are in a delicate situation and should be of the utmost regard in fulfilling the Fund's objectives and maintaining the high quality of its advice.

Mr. Al-Turki submitted the following statement:

The staff has prepared a comprehensive and well-written set of papers for today's discussion. Experience of the last two years has again underscored the importance of ensuring Fund's effectiveness in helping members anticipate and resolve financial crises. The Fund surveillance process also remains the vehicle for timely advice on monetary and financial reforms at national and international levels. However, adjustments need to be made in view of lessons from the recent global economic experience as well as observations of the external evaluators on Fund surveillance. I will offer a few remarks in that context.

In pressing implementation of the Fund's role, the tension is indeed between comprehensiveness and selectivity. Here, strong prioritization is essential in view of not only resource constraints, but also the institution's continued manageability as well as fidelity to the Articles of Agreement. This argues for focus primarily on external sector issues, and the related fiscal, monetary, and real economy matters. As a natural extension of these responsibilities, I welcome the increased attention to financial system restructuring, regional surveillance, cross-country interdependence, and capital account movements. Finally, close bilateral and multilateral follow up of country developments, including the informal WEMD and country matters sessions, is critical and requires continued high priority.

Box 1 provides an instructive listing of pressure that the Fund faces to deepen and extend involvement in non-core areas. Staff's tentative conclusion that core surveillance has actually strengthened despite the greater coverage of non-core areas is reassuring. However, it is important to appreciate that it is unrealistic to expect continued scope for such benign extensions of the Fund's activities.

Vigilance against outside pressures on the Fund to cover non-core issues is critical. This will necessarily require a considerable exercise of judgment as it is unreasonable to expect a definitive a priori determination of what constitutes core or non-core issues. The key here is to avoid an unduly expansive view of the Fund's mandate. This calls for management firmness as well as the Board's own self-discipline in the face of outside pressures.

In picking non-core areas for coverage, staff's focus should be on direct links to the core macroeconomic assessment rather than on ad hoc judgments on the intrinsic appeal of an issue. Poverty reduction, for instance, is of course good in itself. However, the case for the Fund's pursuit of this goal should rest squarely on macroeconomic grounds of links to productivity growth and overall economic performance. The same argument applies to Fund's engagement of other non-core issues.

The Fund should be cautious to maintain the quality of the surveillance process. Staff rightly emphasizes that successful surveillance depends critically on continued candor in dialogue with the authorities and honoring the Fund's role as confidential advisor. This points to the importance of avoiding undue pressure for public dissemination of privileged information that members consider premature or inappropriate.

Regarding use of Early Warning Systems (EWS), the experience so far confirms the need for skepticism and care that the staff report rightly emphasizes. In particular, I remain opposed to a more formal EWS in the manner of the rating agencies. I welcome, however, the extra attention to incorporation of vulnerability analysis in bilateral surveillance. More effort in this regard will be helpful for policy-making in member countries and for the Fund's role in global economic oversight.

Quality surveillance depends critically on a perception of even-handed treatment that takes local circumstances into account on a case-by-case basis. The importance of attention to this aspect is evident in the context of non-core issues requiring evaluation of domestic as well as external agents. Attention to both sides of a transaction is crucial.

Staff's preliminary analysis suggests that use of output gap estimates has not led to a systematic restrictive bias in the Fund's policy advice to members. It will certainly be of interest to confirm the robustness of this result in a more comprehensive study. My main concern, however, is to ensure sufficient recognition of the limited reliability of the gap estimates. This is of particular importance in view of repeated revisions to these estimates for the crucial US and Japanese economies. In the circumstances, I urge staff to qualify the use of output gap statistics with appropriate indications of their reliability. This could take the form, for instance, of providing the estimates as ranges rather than points.

On exchange rate surveillance, I welcome the very useful work with the European Central Bank both before and since the launching of the euro. Staff is also right to stress the importance of keeping abreast of the growing sophistication of exchange rate policy impact studies and extending the analysis to surveillance of developing countries. Here, attention to the members' sensitivities on reporting of privileged discussions on exchange rate issues is appropriate and should be continued.

The Fund's increased focus on financial sector surveillance is appropriate. In that context, I can appreciate the case staff makes for additional information to diagnose crises. However, as the report points out, more staff work is also needed to develop better-targeted indicators of vulnerability. Indeed, knowing what questions to ask can be more important than simply asking for more data. As noted during the Board discussion of the

Asian emerging market financial crisis, analysts mostly missed the crisis signals that were readily available from the debt statistics regularly published by the Bank for International Settlements.

I have always emphasized the importance of greater regional focus in Fund surveillance. The recent financial crises have again confirmed the crucial importance of a better understanding the of the contagion of economic and financial developments from one country to another. Staff has made good progress in incorporating cross-country themes both in bilateral surveillance and in consultations with various regional fora. This is an important development that should be deepened.

Staff is to be commended for the work on multilateral surveillance work carried out in the WEO, the ICM reports, and the WEMD sessions. The general approach to risk analysis through alternative scenarios has been useful. Being forward looking, this work is inherently difficult and will naturally keep staff challenged. Let me stress here that staff reporting of the work in progress should continue to focus on results of more immediate policy significance. Thus, detailed reporting of ongoing research initiatives are better presented as handouts during WEMD sessions and appendices to WEO reports.

The drop since 1996 in resources for bilateral surveillance is in part a reflection of the crisis situations that have distinguished this period. Clearly, the resource balance should be aimed at effective surveillance, with focus on prevention and resolution of crisis. In addressing surveillance complexity, the Fund should avoid taking responsibilities that belong more appropriately to other concerned bodies. We are back then to the basic challenge from the tension between comprehensiveness and selectivity that has to be boldly confronted by management's firmness as well as the Board's self-discipline.

Mr. Yoshimura Mr. Toyoma submitted the following statement:

General remarks

It is only natural that following the Asian crisis, surveillance has focused on issues such as exchange rate policies, financial sector surveillance, and capital account and cross-country themes, to achieve its goal of preventing possible crises from taking place in an environment of increased capital mobility and financial market integration. In this regard, it is appropriate that the staff paper reviews surveillance paying close attention to these issues. This chair appreciates staff's efforts in carefully reviewing the issues pointed out by the external evaluators, while taking into account the Executive Directors' response to them.

Referring to the recent reduction in resources for surveillance, the staff paper insists that increased resources will be needed to attain surveillance improvement. It is true that the scope of surveillance has widened with more complexity, which in a bureaucratic way of thinking would lead one to conclude that the Fund lacks the resources to tackle the increased workload. However, such thinking ignores the viewpoint of managerial dynamics. The change in the international financial environment has demanded that Fund human resources be increasingly allocated to the new initiatives such as PRSP/PRGF, FSSA, and Codes and Practices. Accordingly, the modality of surveillance should adjust to this reality, pursuing maximum results with available resources through prioritization. First, the macroeconomic relevance criterion for taking up non-core issues should be applied firmly. Showing restraint in dealing with issues in which the Fund does not necessarily have expertise could help protect the reputation of the Fund. Second, after thoroughly reviewing any redundancy with external institutions such as the World Bank and OECD, cooperation with these institutions should be pursued further in such a way that the Fund could operate in an area in which it excels. Third, this chair would like to revisit the issue of frequency of Article IV consultations. A longer interval between consultations may be justified for countries with less possibility of a crisis and those with less chance of contagion to other countries when a crisis occurs. If consideration of equal treatment among member countries should prevail, the scale of surveillance on a particular country may change year by year depending on necessity. For example, full-scale surveillance may take place only biennially for a small country with a good performance record.

More systematically, the Surveillance Committee may decide the scale of surveillance in line with the identified necessity for each member country, taking into account the outcome of multilateral surveillance. This chair would like to see the practice be established in which synergy between multilateral and bilateral surveillance could work best, and not be constrained by an artificial division between area departments and the Research Department, eventually saving Fund resources. Lastly, the sense of burden in the transition period would dissolve as the new modality finds it's footing.

Comments on specific issues

Advancement in some areas, including analysis of exchange rate policies, financial sector surveillance, and coverage of the capital account and cross-country themes, is in line with the expected role of the Fund following the Asian crisis. However, non-core issues taken up in an ad-hoc manner remain too large in their coverage. As described later, the criterion of macroeconomic relevance for taking up non-core issues should be strictly applied.

Exchange rate policy is one of the core issues of the Fund. It is simply natural that surveillance over exchange rate policies has incorporated lessons from the Asian crisis that highlighted the importance of sustainable exchange regime and exchange rates. We have several points on which to comment. First, the staff paper points out that silence on exchange rate policy was wholly appropriate in some cases. However, this chair does not believe any reason could justify silence on exchange rate policy, as it is the core issue of the Fund. Second, the foreign exchange regime of a country is determined in relation to the modality of monetary policy and the extent of capital movement liberalization. There is no "one-size-fits-all" solution. In this regard, this chair has serious doubts about the two-corner solution approach. Third, any estimate of sustainable exchange rates is based on presumption and thereby can be used as reference at most. What is paramount is to identify from various indicators market expectation as to whether the prevailing exchange rate can be sustainable.

Disclosure of reliable information can reduce the possibility of speculative selling of a particular currency if the fundamentals of that particular economy are in good shape. The necessary consideration in selecting information on the usability of reserves and short-term debt and so forth is that such information should correctly indicate the country's debt managerial capability. While this chair will wait for the staff proposal, hearing the views of market participants on this issue would be helpful.

With respect to EWS, this chair agrees with staff that it is a useful tool for vulnerability assessment and hopes its practice will evolve in light of experiences. However, we should be mindful of its hypothetical nature and the risk that its disclosure could invite excessive repercussion in the marketplace.

While the staff paper checks the output gap analysis as to whether it is biased or not, that examination only covers advanced economies. This chair would like to see whether the Fund's coherent advice to pursue fiscal consolidation becomes successful in developing and emerging countries.

The Asian crisis presented the necessity to study the mechanism of the contagion of a crisis within a region. While regional economic interaction has been an issue frequently addressed in Europe, it has increasingly become important to study this interaction in other areas, such as Asia. Being placed at the core of regional surveillance by the Fund, such analysis should play an important role in discussions at any regional forum.

It is natural that the Fund talks with supranational agencies when policy is being conducted by a supranational organization such as ECB. It is true that Fund membership belongs to countries, not to such supranational agencies. Consulting with an EU member country about how it votes at the Board of the ECB, however, would be time-consuming and inefficient. The limitation that supranational agencies do not assume any responsibilities under membership and thus consultation with them may not be guaranteed effective, can only be concurred by the capability of the Fund to provide them with distinguished advice based on multinational surveillance and so forth.

This chair agrees macroeconomic relevance should continue to serve as the criterion for coverage of non-core issues. The utmost importance lies in a way to apply the criterion. Arguably, any economic incident could have some macroeconomic relevance, which would result in limitless scope for the Fund surveillance. However, that would not only cause problems with Fund resources, but also leave the impression that the Fund is trying to micro-manage the country in question. Therefore, the Fund's surveillance should be limited to cover incidents that have significant and direct macroeconomic relevance. The selection of issues should, of course, be made country by country.

Concluding remarks

Restrained resources for surveillance and effective surveillance apparently stand in a trade-off relationship with each other. However, this chair believes there is still ample room to improve both considerations and urges efforts from the standpoint of managerial dynamics as described at the outset. Put differently, increasing the Fund resources cannot be justified, and is premature at this stage.

Mr. Lehmussaari and Mr. Palmason submitted the following statement:

Staff has produced an impressive set of papers with substance and quality of the highest standard in the tradition of the previous biennial reviews of surveillance, while taking into account many of the concerns raised by the Board and the external evaluators. As a point of departure, we can agree with most of staff's findings and we share many of their concerns.

Having said that, we find the whole exercise somewhat incomplete. While it is very thorough with respect to reviewing recent experiences, it might have benefited from being more forward-looking. It would have been useful to tilt the balance more in the direction of emerging issues like regional surveillance, early warning systems and the financial sector. In particular, it would have been useful to highlight the financial sector issues, which are only covered to a very limited extent in the report, even if this has already become one of the more important areas of surveillance, albeit, to a degree, by chance rather than by choice.

But we are also somewhat puzzled by the framework used to evaluate the success of the surveillance experience in recent years. More specifically, we have difficulty with PDR being put in a position of having to judge what we consider, to some degree, their own work. Namely, PDR already approved ex-ante the policy advice in Article IV reports which the department is now evaluating ex-post. It is not surprising that the surveillance process scores high when measured with the same yardstick as the original product. Take the section on Output Gaps in Fund Policy Advice as an example. Here, staff has confined the analysis to industrial countries, because "this is the only group of countries for which output gaps are usually reported in staff reports." And staff concludes, "this review does not demonstrate a bias toward tightening in the Fund's policy advice." Even if it were true, we don't think the methods and data used do much to dispose of the criticism of the alleged one-size-fits-all policy approach. To our knowledge, that ill-famed, ill-informed, debate is not confined to policy advice in industrialized countries, but rather in program countries, particularly in the aftermath of the Asian crisis. Let us emphasize that this is not intended as a criticism of PDR or of the authors of the report, but rather to raise the point that this is a rather peculiar way of conducting an audit.

Turning to the concept of value added in Fund surveillance. The external evaluators approached the issue from the point of view of international value added, and greater flexibility in monitoring, "considerably fewer resources could be devoted to industrialized countries overall without any loss in effectiveness or impact." This brings to mind the current practice in reporting. The 1997 surveillance guidance note refers to "flexibility in deciding the length of staff reports and the scope of background documentation, if any." We would argue that, in many cases, the message can be effectively put across in the staff report, and that there is sometimes limited value added in the selected issues papers for industrialized countries, particularly for countries where alternative resources are readily available. But, in cases where a background report is deemed necessary, we would argue that the coverage in the background report ought to be highly relevant to the surveillance exercise and the thrust of the policy debate.

Three recent examples suggest this is not always the case, but please keep in mind that we are not criticizing the quality of the reports or the quality of staff's work. First, in the 1999 Article IV consultation for Denmark, the selected issues paper extensively covered the sovereign asset and liability management in Denmark. That might be necessary in other cases, but, in this case, staff confirms in the opening statement that this is really not an urgent matter; "the Kingdom of Denmark maintains one of the most sophisticated sovereign debt management offices in the world." Second, in the 1999 Article IV Consultation with the United States, the selected issues paper covered "Fixing Social Security and Medicare," and this writing reveals references to an abundance of alternative sources on these issues. Third, the 1999 Article IV consultation on the UK focused extensively on the monetary policy framework and, while we consider this topic to be right on target, we would nonetheless argue that it was unnecessary to cover it in the selected issues paper, partly because the case against the constant interest rate assumption in the inflation targeting framework was well established in the staff report itself. But, an important consideration here is that the leading expertise in inflation targeting is not in the Fund, but in more specialized agencies, including the Bank of England. And, once again, this is not criticism of the excellent work staff did in this case, it is simply a question of resource allocation.

This brings up the observation that staff is chronically overworked. The latest reports indicate that the maximum stress area is in mission work, particularly when staff has to focus on issues which stretch beyond their area of expertise. Why not let off some steam in the area of background reporting for industrialized countries? If the purpose of these reports is to train staff in high quality writing, or if staff members feel the need to write extensively on a specific issue, why not use the Working Paper channel and allow the staff member to write in his/her own name? Also, give staff credit for such extraordinary efforts, as suggested in the external evaluation of research.

On the scope of surveillance, we believe that bilateral surveillance should focus on core issues, i.e., exchange rate policies and their consistency with macroeconomic policies, and financial sector and capital account issues, as well as structural issues when they are of relevance to macroeconomic performance. However, as the staff points out, prioritization is needed due to an expanding agenda and resource constraint. Therefore, the Fund should only build up its own expertise, including with respect to financial sector issues and standards, when this is considered necessary and this relates to the view that the Fund should strive to cooperate more effectively with other international organizations.

Overall, we find surveillance over exchange rate policies has been adequately strengthened in the aftermath of the Asian crisis. But let us add an observation which relates to the question of the sustainability of exchange rates. We find that, at least so far, the focus is more on exchange rate regimes than the sustainability of exchange rates. In box 5 there is a reference to both Norway and Finland in this respect. We agree with the thrust of the claim that these are good examples of the treatment of exchange rate policies. However, as a general observation, we find that the focus is still mainly on the regime rather than on the sustainability question, which is the "real" surveillance issue in the international value added context. We would tend to agree with Mr. Wijnholds that the coverage of exchange rates, along with the other issues he refers to in his gray, could be interpreted as falling short of what is put forth in the subsequent sets of guidelines.

For non-core issues, macroeconomic impact should continue to serve as the criterion. The staff report indicates that labor market, social security and other structural policies were covered in almost all industrial country reports reviewed. While these are important topics, the staff should continue to be selective when taking them up in the surveillance process.

We appreciate staff's recent efforts to incorporate cross-country themes in the bilateral surveillance. In particular, the topic of the first thematic cross-country study concerning Europe, Exchange Rate Regimes in Selected Advanced Transition Economies (SM/00/43), is very timely and interesting. In addition to cross-country themes, regional issues have also come to the fore. On euro area surveillance, the experience has been that the Fund has managed to integrate bilateral consultations with euro area member states, and semi-annual discussions on euro area monetary and exchange rate policies, in a way that well serves the goal for regional surveillance, i.e., analyzing area wide policies and their implications for participating countries' policies, as well as effects on neighboring countries.

Multilateral surveillance, as it is now reflected both in the WEO and ICM, is also highly regarded outside the Fund. However, we believe that reports could be more concise in order to enhance their effectiveness. There is also clearly a need to incorporate multilateral surveillance with the increasing work on cross-country and regional issues and to clarify how this all will feed into bilateral surveillance.

There have been many proposals, including from external experts, to pay more attention to vulnerability assessments and to develop early warning system models. We support these proposals, not least because explicit incorporation of vulnerability assessments into the surveillance framework would deepen the analysis of capital account and financial sector issues. In the use of EWS models and interpretation of their results, we agree with the staff that caution is warranted. To the extent that the Fund uses EWS models, it must make it very clear to the public that this work is complementing the Fund's other analytical research of vulnerability aspects. We can thus accept publication of such results, provided, of course, that the "mechanical nature" of the models is clearly explained and official data is used.

Surveillance is one of the Fund's main tasks and should also continue to be so in the future. Furthermore, we should not compromise with continuity in surveillance and uniformity of treatment, which are also prerequisites for cross-country and regional surveillance. However, we support that countries in good shape or which are not systemically important can continue to be under less scrutiny than others.

Many initiatives affecting surveillance are in a pilot project phase (for example FSAP/FSSA). At this stage, it is too early to assess to what extent they should be integrated into surveillance. Therefore, we welcome the staff's proposal on a follow up paper after the Board has discussed these various initiatives.

Concerning publication of Article IV reports and recent requests for deletions/changes (UK and Belgium) we would like to wait for the review of the pilot program before assessing these and other issues that the publication of Article IV reports gives rise to. However, we would add that, a priori, we do not see it as a bad thing that the content and presentation in Article IV reports is put under the microscope in connection with their publication. We also believe we may have to take a new look at the old notion that there is a tradeoff between confidentiality and transparency. We also have to think about how presentation of the various elements of an Article IV discussion, the staff report, the buff, and the summing-up can best be presented to reflect the three-dimensional view of the staff, the authorities, and the Board.

Provision of timely and accurate data is crucial to Fund's surveillance. The 1997 Surveillance Guidance Note on Data, namely that staff reports should give a candid assessment of data deficiencies, has not lost its relevance.

And finally, we agree with Mr. Bernes and Mr. Chelsky that there is merit in following up on the proposal to prepare an action plan to respond to issues endorsed by the Board while these issues are still fresh in our minds.

Mr. Cippa submitted the following statement:

Introduction

I thank staff for the wealth of information presented in this interesting set of papers. Reviewing the implementation of Fund's surveillance is a daunting task in the best of circumstances given the large number of bilateral surveillance exercises, the range of the topics covered, and the interaction with multilateral surveillance. For this review exercise, the large number of initiatives that have been taken to expand and refocus Fund surveillance has compounded these fundamental difficulties. Many of the measures aimed at strengthening the international financial architecture have and will have a significant impact on surveillance. The staff's task was further complicated by the input received from the discussion of the external evaluation of Fund surveillance last September.

In terms of timing, it is unfortunate that this paper has to be discussed before a number of important pilot projects related to surveillance could be reviewed. For instance the future of the FSAP/FSSA, the publication of Art. IV reports and the review of the data standards will all have important implications on the way our institution will carry out its surveillance activity in the future. Including these issues in the present review could have allowed a potentially more productive discussion about the principles of Fund surveillance and possible changes. Under these circumstances, it will be important to have a follow-up report to today's paper, as suggested by staff. Ideally, this report should be discussed before the annual meetings.

In terms of last year's external evaluation of Fund surveillance, I am somewhat confused how this review fits in the follow-up exercise. At the time of the Board discussion of the external review management had promised to provide a program outlining precisely how we were going to deal with the issues raised by the external evaluation. This program has yet to come. The principle message I got from the review in respect to the these issues is that nearly all is well, since we are moving in the right direction in most of the issues identified in the external evaluation. Like Mr. Wijnholds and Ms. Lissakers/ Mr. Sobel, I think the staff is a bit too sanguine. While I appreciate staff's further analysis of the external evaluators' points based on a much more comprehensive sample and taking into account developments since the report was published, it remains unclear to me how we are specifically following up on the various issues that were raised. I agree with Messrs. Bernes/ Chelsky that we need an action plan to articulate clearly how we are responding to the external evaluation.

Thrust of Fund Surveillance

In general, Fund surveillance has faced up well to the significant challenges over the last years. In my view, efforts to increase the focus on data and policy transparency, to take into account capital account and vulnerability issues, and to strengthen regional surveillance and its integration into bilateral surveillance have clearly made surveillance more effective. At the same time, enhanced coverage of new or non-traditional areas has posed a significant risk of overstreching the staff resources. This is true not only with respect to quantity, but also to quality. While we are tackling both of these issues by increasing staff resources and aiming at recruiting a different skill mix, we have to be acutely aware of the risk of losing credibility with our members when bringing up issues in the context of surveillance for which we lack sufficient know-how.

Core and Non-Core Issues

The topic of how the Fund should deal with core versus non-core issues has already been discussed a number of times. Reading today's review, I have the impression that we are moving in the right direction. The range of core issues has appropriately been widened to now include topics related to the financial sector, to the capital account and to events that could have significant cross-country effects. Recent experience has shown that all these areas are of relevance to the Fund's mandate to ensure a stable international financial system. The Fund has a recognized expertise in these areas and should, therefore, concentrate its surveillance activity on these whatever the country.

By contrast, our institution does not have sufficient expertise in non-core areas, such as assessing the quality of a country's governance or the adequacy of its social system. Because the Fund is truly universal and surveillance applies to all our members, there is a strong pressure on our institution to widen the scope of our activities and to implement the agendas developed in other fora. For the sake of our institution's credibility, this mission creep should be resisted. The Fund should not be perceived as the "gofer" of the international community.

This does not mean, however, that non-core issues are unimportant and should be disregarded altogether. It means that non-core issues should not be covered systematically, but only when they have a significant influence on the country's macroeconomic situation. Staff, although not experts in these fields, should develop awareness for these issues and an understanding of their interactions with a country's macroeconomic environment. In such cases, close cooperation with the relevant agencies that do have the expertise is essential and the assessments of these agencies should be taken up in our reports.

Does the Fund do enough in its core areas? I feel that this remains an open question. The external evaluation report pointed out that the Fund should concentrate more on its core areas, particularly for its large industrialized members. The present review comes to the conclusion that the Fund's surveillance is already sufficiently focused on the core issues of its competence and mandate. Given the summary nature of the current documents, it is, however, difficult to make a conclusive judgement on the validity of this assessment.

Vulnerability Assessment

Including vulnerability assessments more systematically in our surveillance is a crucial element for making the exercise more effective. Since the development of vulnerability indicators is still ongoing, the systematic inclusion of such an assessment is still in its initial phase. I urge the staff to build on the first steps that have already been made to expand vulnerability analyses. While recognizing the need for a cautious stance on the systematic inclusion of formal EWS models in the bilateral surveillance process, I think we should be careful not to limit vulnerability assessments unduly because of potential market sensitivity. By including new indicators that take into account the increased importance of the financial sector and debt-related issues, we are only expanding the envelope of the Fund's traditional role and enable the Board to adequately assess the economic policy stance of its members.

Effective surveillance and vulnerability assessments hinge on adequate data provision. In this respect, it is important to continue our efforts to improve the existing data standards. The tasks before us in the area of debt data and of macroprudential indicators are difficult and complex, but completing them will prove invaluable to ensure effective surveillance.

Mr. Faini submitted the following statement:

The strengthening of surveillance plays a key role in the reform of the international financial architecture. In this well-written and well-thought out report, staff reviews the changes in surveillance that have been implemented since the last biennial review. This is an interim report. It does not aim at providing substantive recommendations for reforming surveillance. For this, we need to advance our work in crucial areas, namely transparency, standards and codes, financial sector assessment, and, more generally, vulnerability analyses. It would have been preferable to take stock of the ongoing work in all these areas before proceeding with the review of surveillance. Unfortunately, such a review could not be postponed further. Nonetheless, we will need to return to these issues. We agree with staff that somewhat later in the year, before the Annual meetings, a new report should be discussed by the Board with a view to finding ways to fruitfully integrate the work on standards and codes and on financial sector assessment into surveillance.

In the meanwhile, the report provides a welcome opportunity to review the changes that have been introduced in the surveillance activity of the Fund. The report is fundamentally upbeat. It argues that work at the Fund has advanced in line with Board guidance. It takes a comprehensive look at hundreds of reports to conclude that there has been increasing emphasis on crucial issues such as exchange rate policies, financial sector assessment, capital account issues, and cross-country themes. In many respects, it provides a more complete and also more favorable assessment of surveillance than the external evaluators. The report is also candid. It highlights with no reticence the areas where progress has not been satisfactory or has fallen short of expectations.

Is surveillance effective?

This question was raised by the external evaluators. Their assessment was very blunt: "it surely has to be accepted that surveillance is hardly ever going to be a primary influence on a country's policy action (p. 82)". It is perhaps unfortunate that the review does not tackle this question, with one significant exception, namely the discussion on exchange rate policies. Two findings stand out. First, staff's advice on exchange rate issues was provided in 88 percent of the reports (100 percent for transition countries). Second, the authorities response was reported only in 31 percent of the cases where staff volunteered their advice (quite remarkably this figure rises to 66 percent for emerging markets). Unfortunately, there is no way to know whether the limited response rate was due to sensitivity concerns by staff or the authorities. More crucially, it would have been interesting to assess whether staff advice had any impact on subsequent policies.

Does surveillance focus on the right issues?

There have been significant changes in the focus of surveillance. We agree with staff that surveillance has been strengthened in a number of key areas such as financial sector assessment and capital account issues (for both areas, external evaluators argued that there were wide margins for improvement). However, we remain of the view that, too often, these issues and, more generally, the assessment of vulnerabilities are not well integrated in the core of the report. Staffs seem to agree, at least implicitly, when they notice that in only a limited number of cases the art. IV reports "discussed links between the capital account and financial sector policies" (p. 25). Similarly, in the background papers, staff note that "few reports for emerging economies – whether on a fixed or a flexible exchange rate regime – explicitly mentioned external vulnerabilities and banking sector fragility in discussions of exchange policies" (p. 8). This is not a secondary shortcoming. The fragility of the financial sector to, say, changes in interest rates and exchange rates cannot be assessed independently of a thorough assessment of the macroeconomic situation, which should reveal whether the exchange rate is grossly appreciated or whether interest rates need to be raised to defend the currency or to stem inflationary pressures. Similarly, external vulnerability indicators cannot be seen in isolation from macroeconomic conditions. The ratio of external debt to GDP may not initially sound any warnings; a real depreciation, however, may lead to a substantial deterioration in such an indicator. This was indeed the experience of many Latin American countries in the eighties. In Mexico, external debt soared as a percentage of GDP from 33.7 percent in 1994 to 58.7 percent in 1995. To sum up, vulnerability analyses should not be seen as a stand-alone addition to the staff report, but should be fully integrated in the analysis of the macroeconomic situation.

Some priorities for improving financial sector surveillance

Lack of data can represent a major constraint to a well-informed and comprehensive assessment of financial vulnerabilities. We are therefore concerned by the finding that staff reports have not always identified gaps in existing information and reported the reasons for them. Art. IV reports should be extremely candid in assessing the impact of deficiencies in the timeliness and the quality of existing data not only for the financial sector but also, more generally, for the external debt and reserve situation. Notice that progress in this area is also crucial to improve the effectiveness of the Early Warning System. It is somewhat baffling to find that financial vulnerabilities do not seem to play a statistically significant role in explaining balance of payments crises. Most likely, this disturbing finding must be attributed to data deficiencies. Improving the quality and the timeliness of existing information on the financial sector could well contribute to strengthen our understanding of the link between financial vulnerabilities and currency crises. This could spark a virtuous circle where progress in the EWS would in turn indicate additional avenues to improve the quality of existing data.

How are non-core areas covered?

Regarding non-core areas, we agree with staff that selectivity should take priority with respect to comprehensiveness. Non-core areas should be addressed only when they have demonstrably serious macroeconomic implications. Moreover, even in those instances, there is a case for relying on the expertise of other international institutions that have a comparative advantage in the field. We were pleased to see in this respect that, at least for environmental issues, the Fund is actively collaborating with other specialized international institutions. The way poverty issues are covered in our surveillance reports is however less satisfactory. Staff note that "in contrast with the coverage of other non-core issues, there is not usually an explicit link to the macroeconomic assessment." Previous Board guidance on this matter asked the staff to assess the effect of macroeconomic policies on the poor. As with vulnerabilities, it is essential that the coverage of poverty is not seen as an addition to the staff report, but is fully integrated into it.

Is there a gap in our measure of potential output?

We are pleased to see that staff takes a close look at the use of the output gap in surveillance reports. This concept has an ominous presence in reports for industrial countries. The information collected by staff suggests that there is not a systematic bias either in the sign of this gap, or on the advice for monetary policy that staff draw from such an indicator. Still, some questions remain. First, is there any clear indication that the output gap is a good predictor of inflationary pressures compared, say, to the difference between unemployment and NAIRU? While staff present a well-informed discussion of the various approaches to the measurement of the output gap, they do not devote much attention to whether some of the proposed measures are accurate predictors of inflation. Second, the use of the output gap implicitly relies on the notion that potential output is exogenous. This may not be the case for small economies that are open to international factor flows. Low unemployment and high wages may foster both skilled and unskilled immigration, relieving the labor supply constraint. Under these circumstances, is there any use in the concept of output gap?

Is there a binding resource constraint?

Staff claim that there has been a drop in total resources devoted to bilateral surveillance between 1996 and 1999. Staff also note the increase in the delays of consultation. However, I would not overestimate the relevance of these data. First, 1996 was a peak year. If the comparison is extended over the full decade there is no noticeable trend toward a deterioration in the Fund surveillance activity. Second, the data on delays do not control for the fact that after 1997 many countries moved to a biennial cycle. This fact in itself should lead to a rise in the delays between consultations. To assess whether delays have increased we need to focus on more homogeneous data that only include countries that have remained on an annual cycle. Third, it is perhaps worth recalling that the budget has already allocated sizeable resources to both the strengthening of surveillance and, more specifically, to the financial sector assessment exercise. Finally, the data in table 10 suggest that the increase in the workload of the Board is a factor to be reckoned with. While the number of hours devoted by the Board to consultations has been rising steadily, the percentage of Board hours spent on consultations has declined substantially. The implication is that total Board hours have risen substantially, indeed they have increased from 507 in 1996 to 630 in 1999. The attempt to alleviate existing resource constraints must also reckon with this fact.

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

We welcome the opportunity to once again review the implementation of the Fund's surveillance and consider the several pending issues accumulating over the past two years. It is also a good time to reflect on the recommendations of the external evaluation team as well as the proposals put forward by recently invented international and regional fora, with a view to improving the Fund's surveillance process, and keeping abreast of the rapidly changing financial world. It is our mission to move forward, implementing those recommendations that receive more or less Board and IMFC endorsement, and deliberating on those that require fine-tuning consideration of the Board. Staff and management are to be commended for the comprehensive set of reports presented for the Board discussion today. We are appreciative of the hard work and efforts put into drafting each paragraph, preparing each box and table, and citing all the relevant documents.

Core versus Non-Core Issues

We acknowledge the increasing number of international and regional fora, and their demands for a 'better' Fund, as the staff tried to summarize in Box 1. It is important, however, to have a clear set of criteria as to which types of proposals put forward by which types of fora and their members should be reasonably included for our further consideration. We specifically disapprove of the reference to any national forum and its demands. It is not possible for staff to keep track of all such 'fora' and uphold the principle of uniform treatment in this respect.

As regards the issue coverage, we are sympathetic to management and staff over the evidently increased external pressures for the Fund to broaden its scope of surveillance to non-traditional areas. However, the principles and professionalism of the institution have to be preserved, and thus self-restraint should be exercised. This is governed by the Fund's mandate. Outside the core areas of the Fund, which are yet to be legitimately defined, with less ambiguity, staff takes a position that non-core issues may be relevant only when they are judged to be 'closely linked' to the macroeconomic situation of a particular member country. Flexibility and selectivity will, therefore, come into play, depending on the country specifics. This is indeed a judgmental call and provides room for undesirable bias. At the same time, we recognize the difficulty in arriving at a standard guideline, especially for something that is not static in nature. However, it should at least be attempted, and modified when necessary.

We agree with the need for strengthening Fund surveillance, but this by no means is equivalent to expanding the coverage of issues for the sake of 'comprehensiveness.' Rather, it is 'limited comprehensiveness' that we should aim for. This limitation is imposed by the Fund's Articles of Agreement, staff and capital resources, and competence.

Notwithstanding the Board guidance referenced in Box 11, we are of the view that corporate governance, environmental issues, poverty, health care and other social issues, including human and labor rights, are not in the domain of the Fund, and would like to call on Directors to refrain from commenting on them during Board discussions. We also think that trade liberalization per se should be left to the World Trade Organization.

Exchange Rate Policies

We fully agree with the fact that surveillance over exchange arrangements and exchange rate policies is the heart of the Fund's Article IV consultations. This core activity aims to ensure that members' policies are consistent with the objectives of orderly economic growth, price stability, and sustainable balance of payments. To this end, surveillance performance over the past two years has been considerably improved; discussions on the issue have been candidly and extensively reflected in staff reports. Board discussions have also been very fruitful and interactive.

Often, unfortunately, such issue is considered highly sensitive, thus raising a disturbing problem for the countries participating in the pilot project on voluntary release of the staff reports. It will be regrettable if this pilot project stands to hamper the traditionally candid dialogues between the mission and the authorities, and also deprive the Board of the opportunity to discuss exchange rate issues in detail, with the implication being its complete omission from the summing-up. To some extent, this practice does not differ much from that of a side letter. We would like to put on record that we strongly disapprove of the difference in treatment of member countries simply because one group is willing to publish the reports, while the other is not. We also wonder if the explanation in footnote 23 is directly linked to the publication issue. Concern over publication should not override the main objective of Article IV discussions. Unless the issue regarding the editing of the report is satisfactorily resolved, we tend to be forced to sacrifice either the frankness of discussions or the Board time, or both. We, therefore, would like to propose that the pilot project be reviewed as soon as possible.

One development should be pointed out here. Table 1 on page 19 shows that much more emphasis has been put on emerging market economies. In all respects, analyses have been more comprehensive. This is reasonable given the nature and concentration of the recent financial crises. We would, however, like to note the reduced coverage for industrial countries in terms of regime assessment, level assessment, and authorities responses. Staff argues that the invent of the euro accounts for the shift in discussion from bilateral to ECB level. It may be interesting to see how coverage for other developed countries outside the euro area has evolved.

Financial Sector Surveillance

We share the view that the financial and economic sectors have increasingly been intertwined. This is due largely to the increased globalization and liberalization of trade and financial systems. We note, and welcome, the intensified efforts to identify financial sector weaknesses and assess the regulatory and supervisory framework in the context of Article IV surveillance. Notwithstanding its significance, it is important not to lose sight of the main mission. What serves as the basis of judgment is whether or not the situation in the financial system imposes any systemic risk, thus having major macroeconomic implications. Based on this criterion, we see no direct or significant connection between macroeconomic developments and the issues of corporate governance and privatization of state banks, for example.

On FSAP/FSSA, although we see the usefulness of this exercise, we would like to reiterate our reservations about linking financial sector stability assessment, which is still at an infant pilot stage and on a voluntary basis, to the formal Article IV consultations. It is premature at this stage for staff to conclude that "the analysis of vulnerability will also need to incorporate the in-depth assessments of financial sector soundness made in the Financial Sector Assessment Program (FSAP) and Financial Sector Stability Assessment (FSSA) pilots" (paragraph 5, second bullet). This, in addition, contradicts the message in paragraph 6 which acknowledges the initiatives pending Board consideration. To satisfy the wish of many Directors who are willing to have this assessment as an integral part of Fund surveillance, we would expect to see staff proposal on "how to incorporate financial sector assessments more systematically into annual Article IV consultations" (Concluding remarks by the Acting Chairman on Financial Sector Assessment Program, Buff/99/132). Nonetheless, the important issue of confidentiality and secrecy has to be addressed first.

We have a similar reservation regarding the integration of ROSCs into the Article IV process and staff reports. At this stage transparency reports are still being experimented and participation is voluntary. The Board has considered it premature for the Fund even to decide on whether to produce transparency reports. Moreover, there seems to be agreement that the Fund's assessment of the observance of standards should be confined to the core areas of the Fund where it has relevant expertise. Yet, Table IX-2 on page 114 of the staff report shows that the Fund has ventured progressively and outside its jurisdiction into the non-core issues when conducting the Article IV surveillance. We also note the misleading presentation of this table in the sense that the Fund's involvement in the non-core issues is underestimated here; surveillance and review is in fact extensively conducted in many program countries and reported in the review papers.

Capital Account Issues

We support the conclusion that there are close linkages between developments in the capital account and those in the financial sector, with broader implications for the whole macroeconomy. We, therefore, welcome the improved coverage of capital account issues and the approach adopted by the staff. Nevertheless, capital account issues should not be treated only in the context of balance of payments, developments in the capital markets are also of significance. There are a vast range of players, products, and off-balance sheet transactions in the global markets. The perception and behavior of the foreign exchange markets and the capital markets in general are of macroeconomic relevance, especially to small, open economies.

We are pleased to take note of the more cautious stance on recommending capital account liberalization. "Given the unsettled views in the economics profession on the costs and benefits of liberalization," it is appropriate to focus on the analysis of the size and composition of capital flows and their macroeconomic consequences, and of the present capital account policy regime. While refraining from encouraging more liberalization, staff suggestions should guide toward building both short- and medium-term frameworks for preparing and strengthening the domestic fundamentals in order to cope with, and reap the full benefits of, the increased globalization and liberalization.

Bilateral, Regional, and Multilateral Surveillance

The increased efforts at integrating bilateral, regional, and multilateral analyses is indeed a welcome direction in an attempt to early identify and preempt potential contagion effects by pooling available information and resources. We also welcome more issue-oriented discussions, cross-country themes, in surveillance reports as well as WEO, WEMD, and ICM reports.

Mr. Portugal and Mr. Junguito submitted the following statement:

Overall Assessment

We welcome the opportunity to review the results of the ongoing efforts to strengthen Fund surveillance, in light of the changes adopted since the last Biennial Review and the Board's discussion of the recommendations of the External Evaluation of Fund Surveillance. Our overall assessment of the review is supportive of the results which indicate that surveillance of core areas --namely, fiscal, monetary, balance of payments, and exchange rate, as well as the financial sector-- has strengthened since the Asian crisis.

Core and Non-Core

Our view in regard to non-core areas is that the Fund should involve itself in these areas only if the non-core issue is essential for macro-economic stability and not simply if it has a macroeconomic impact. In such exceptional cases, as suggested by Mr. Shaalan, the Fund should receive input from other organizations with appropriate competence.

Exchange Rate Policies

As staff shows, Article IV consultations for industrial countries have usually paid significant attention to exchange rate policies, although the degree of coverage has varied across countries and time. The emphasis of staff recommendations has been on the formulation of fiscal and structural reforms needed to support a chosen exchange rate regime, which is in line with the Board's discussion on exchange rate regimes. We note that there is a high proportion of cases where authorities' responses to policy recommendations by staff are classified as vague or none. This latter reaction is understandable to the extent that very explicit comments by authorities on exchange rate issues --both in industrial and emerging economies-- have extreme sensitivity. The emphasis on exchange rate policies in industrial countries should have the same relative importance to that given in staff reports of emerging, transition, and developing economies.

It is essential that the policy analysis for the United States, Japan, and the euro area pays greater attention to the international implications of the dollar, euro, and yen's movements.

The staff report notes that the coverage of exchange rate policies in emerging, transition, and developing economies increased in the wake of the Mexican and Asian crises. This is a welcome development and the result of the recommendation of the previous Biennial Review. Another welcome trend is that discussions of exchange rate policies have begun to take into account contagion and regional issues which have been highly significant in recent years.

Vulnerability Analysis

Regarding the benefits of including information on usability of reserves, short-term debt, and market sentiment, although we recognize that they are useful for effective diagnosis of a potential crisis, we consider that in conditions of vulnerability, its publication could be extremely risky. Such information could be provided confidentially. This issue raises the question of the trade-off between candor and publication of Article IV reports.

Financial Sector Surveillance

We find adequate the clear trend toward greater discussion of financial sector issues and the more systematic cover in staff reports of financial sector vulnerabilities, prudential regulations, and the emphasis given to the linkages between the financial sector and overall macroeconomic performance.

Capital Account

We are glad to find out that a close reading of emerging market staff reports indicates that there has been a deeper discussion of the composition of capital flows and on the regulatory regimes that influence short- or longer-term inflows, and that a certain degree of silence on recommendations of capital account liberalization has been observed in more recent staff reports.

Cross-Country Themes and Multilateral Surveillance

As to regional surveillance over monetary unions, we support staff efforts to strengthen it, both in the case of the euro, where consultations are advanced both with individual national authorities and the relevant EU institutions, as well as with other regional monetary unions, such as the West African Economic and Monetary Union and the East Caribbean Currency Union. This, however, should not be a substitute for bilateral surveillance of the individual countries composing the monetary union. We also found of particular interest the Fund's participation in regional initiatives to foster policy coordination in regions other than currency union and welcome the greater involvement of the Fund in cross country and regional issues.

Output Gaps and Fund Policy Advice

In regard to the relationship between the output gap and policy advice in industrial countries, while we share the conclusion that the analysis shows a clear link between the sign of the output gap and Fund advice on monetary policy, the same cannot be said about the recommendations of fiscal policy stance. Indeed, despite the fact that the output gap analysis for most country cases indicates that output is below potential, staff recommendation as shown in Table 9 of Supplement 1 almost without exception is towards maintaining or tightening the fiscal stance. Although the staff indicates that explanations could be found in the fact that the sample covered EMU countries in the process of convergence to the stricter fiscal EMU criteria, it could also indicate a potential bias in staff policy recommendations. Staff opinion on this subject is welcome.

Operational Aspects of Surveillance

We agree that the 12-month Article IV consultation cycle acts as the bedrock on which bilateral surveillance should rest. Although in the previous Biennial Review the Board encouraged greater flexibility in the Article IV consultation process, that allowed the number of countries on longer consultation cycles to increase, we believe that the criteria limiting the eligibility of countries for a longer consultation cycle should be applied very strictly. As we argued in the past, a great comparative advantage of the Fund is its role of gathering and disseminating cross experiences. While we share the staff's explanations on why the length of Article IV reports has increased, we would like to express our concern for the number of delays in the completion of Article IV consultations, which appear to have risen. We expect to hear concrete proposals from the staff concerning this situation.

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

Staff have prepared a very comprehensive set of papers for this discussion. Their retrospective analysis provides a clear picture of how the Fund has increased the coverage and content of its surveillance documents over the past couple of years.

The main paper does not, however, provide us with much in the way of strategic direction for the future of Fund surveillance. But that, perhaps, was not its intention. As the staff have noted, there are a large number of other initiatives currently under discussion which will have an important bearing on the nature of Fund surveillance. Nevertheless, it is now over six months since the Board discussed the external evaluation of Fund surveillance. We agreed that it would be sensible to draft an action plan in the light of that discussion. We think it would be useful therefore if staff could give us a clear exposition of how all these various strands, including the external evaluators' recommendations, are expected to fit together over the coming year.

In terms of next steps, we think the Board should be given the opportunity to set concrete surveillance guidance – perhaps including elements along the lines of Mr. Wijnholds' imaginative proposals - for the staff in the light of these other policy discussions. We may therefore need another discussion of surveillance later this year.

Related policy issues

A word on other initiatives. As staff have pointed out, there are a number of important policy initiatives on the agenda that will have an important bearing on the future of Fund surveillance. We should not prejudge the outcome of those discussions. In particular, we think discussion of the implications of publishing Article IV reports will have to wait until we have had the results of the pilot project. That said, we think it would have been useful, and also in keeping with the retrospective nature of the paper, if staff could have included some factual information on the amount of surveillance which now gets published compared to the time of the last review.

We do think, however, that the issue of codes and standards and, to an extent the Financial Sector Assessment Program, will be of critical importance to the way Fund surveillance is conducted. They are a crucial element in the determination of which issues, both core and non-core, should become the subject of surveillance and monitoring for which country. They are also a good example of joint working between the Fund and other institutions, notably the World Bank. They should also facilitate measurement of the impact of surveillance by providing benchmarks against which improvements in economic policy-making can be measured. Needless to say, therefore, we continue to believe that ROSCs and FSSAs should become an integral part of the Article IV surveillance process.

PRSPs also present a new agenda. Again, without prejudging how these evolve over time, it is clear that the Fund, in close cooperation with the Bank, will need to consider carefully how its surveillance operation should operate in this area. Without careful consideration of ongoing monitoring arrangements for PRSPs, and the associated lending facilities in the Fund and Bank, the PRSP process itself will be weakened.

More generally, the paper could also have said a little more about co-operation and collaboration with other institutions, especially the World Bank. There has been a welcome increase in the reported use of outside information and analysis. It would have been useful if this had been more clearly documented in the paper. As such, it is difficult to have now a discussion on the need to systematize and organize the Fund's use of outside information, as recommended by the external evaluators.

Core versus non-core issues

We find the distinction between core and non-core issues unhelpful. Perhaps traditional and non-traditional would have been better. To us, a core issue is an issue that is of significant importance to a country's macroeconomic performance. It has become increasingly clear that, in a rapidly changing global economic environment, what represents a core issue for a particular country will vary from country to country and from time to time. At the moment, for example, surveillance of the financial sector largely relates to the banking sector. But this will need to change over time. Similarly, corporate governance is likely to be an important issue primarily for those countries which receive significant equity inflows. Moreover, it is also clear that, in this changing global economic environment, and taking all countries together, the range of core issues is becoming increasingly broad. In this sense, some of the economic issues which are defined by staff as non-core are very much core for certain countries. Essentially the staff need to prioritize issues within countries according to their relevance to a country's vulnerability.

There will of course always be gray areas when it comes to deciding whether a particular issue is a legitimate target for Fund surveillance. And we agree that where surveillance covers non-traditional issues, it will be incumbent on staff to explain why a particular issue is of significant importance. Moreover, there is a question as to the extent to which the staff should rely on outside expertise in drawing up its assessments of some non-core areas; with a presumption that they should do so to the extent possible, and not seek to create in-house expertise beyond that necessary for being an 'intelligent customer'.

It is also clear that we are still searching for a consensus on this matter. Views differ on whether, or the extent to which, governance or social policies, for example, should be covered in Fund surveillance. This partly reflects the differences in emphasis on the fundamental purpose of the Fund, be it reducing vulnerability to a crisis, improving living standards, or maximizing growth. These are all legitimate purposes of the Fund. But the extent to which one ranks one above another will determine one's view on the issues on which surveillance should focus. The paper could have done rather more to motivate a discussion of these deeper issues, which may in turn have helped us to come to a clearer idea about the purposes of surveillance.

Incidentally, we also thought that the detailed section on output gaps was misplaced. Those who have criticized Fund for adopting a 'one size fits all' approach to policy advice have done so primarily because they think the Fund pays too little attention to a country's stage of economic development, and its particular legal, institutional, and cultural circumstances.

Impact

Surveillance must of course serve a purpose. We were disappointed that the paper made little attempt to assess the impact of surveillance in securing adjustments to policy and did not, therefore, provide any recommendations on how impact could be enhanced. We recognize that this is a difficult issue, especially in the context of multilateral surveillance. But it is also a crucial issue. As noted above, we believe that codes and standards themselves will facilitate assessments of the impact of surveillance.

Vulnerabilities

Fund surveillance has increasingly focused on the vulnerabilities facing an economy although it has, as Mr. Wijnholds notes, still further to go on this front.

We would note in this context that many financial regulators are moving towards a risk-based approach in which they focus their attention on those areas which are most worrisome. There is a case for Fund surveillance doing the same. The FSAP program represents something of a step down this route. And the results from this program have been encouraging. However there is scope for further exploring approaches to vulnerability, such as the development of stress testing. We appreciate that this is easier said than done and that the process may, in some cases, be hamstrung by a lack of data. But we consider that it would be worth pursuing.

There is also a substantial amount of work being undertaken on vulnerability indicators. While it would be inappropriate, and occasionally dangerous, to use these indicators in a mechanical way, they do have a role to play as a "flashing amber light device". We hope that, over time, they will become an increasingly regular feature of surveillance papers. A similar comment applies with respect to macro-prudential indicators more broadly. The same arguments also apply to Early Warning Systems, although we think that such models are not as transparent as simple vulnerability indicators and are therefore subject to misinterpretation.

Capital account issues

The coverage of capital account issues has improved significantly over the last few years. There is, however, still more to be done in terms of deeper discussion of the stability and sustainability of various classes of capital flow and in ensuring that this happens in a greater proportion of Article IV reports.

There are of course still problems in doing this in some countries which have liberalized but which have not yet set up the infrastructure necessary to permit effective monitoring. These data deficiencies should be highlighted in the relevant staff reports. We think the identification of data deficiencies more generally is a perfectly legitimate outcome of the surveillance process. We hope the forthcoming paper on data provision to the Fund will provide some specific action points in this respect.

The Financial Stability Forum Working Group on Capital Flows has been considering the case for enhanced monitoring of national balance sheets which may provide some useful recommendations for the further enhancement of surveillance of capital account issues. In particular, vulnerability indicators should ideally cover the aggregate position of the sovereign and private sectors taken together.

We were somewhat surprised to note the reluctance of staff to take clear positions on capital account liberalization. This is inconsistent with the role we want the Fund to play in providing advice on the appropriate pace and sequencing of the liberalization process. There has been a huge amount of work on this issue in recent years, and staff are surely now in a reasonable position to start delivering balanced and sufficiently nuanced advice.

Industrial countries

Some have argued that the Fund should re-direct its surveillance resources away from industrial countries towards emerging markets or developing countries. This would permit the Fund to focus on those countries which are at greatest risk of a crisis, or on those countries where Fund surveillance is thought to have a greater impact.

We have some sympathy with this view and believe that there is scope for some streamlining of the resources devoted to industrial countries. The extensive focus on the constant interest rate assumption in the recent UK Article IV was, for example, surely not the most productive use of staff time. There is a sense sometimes of a predetermined number of staff being allocated to a particular country and then having to find research-like topics to fill their time.

This streamlining should however be a process of evolution rather than revolution. In particular, we do not agree with those who compare the size of the US with the euro area and conclude that too many resources are devoted to EU work. It is appropriate that more resources are devoted to the EU to the extent that policies differ across the EU – and policies do differ. This situation may well change. But it will take time.

Multilateral surveillance

We have a few brief comments on multilateral surveillance. The quality of the two main products – the WEO and the ICM – is very good. We think there is an issue, however, regarding the links between multilateral and bilateral surveillance. There have been some cases recently in which the experiences of other countries have proved useful in selling a policy message to the country under review. We think this practice could be expanded. The increase in regional surveillance is also to be welcomed. It should be used more actively in Article IV reports on individual countries to draw relevant comparisons and lessons, rather than just presented as background papers.

Finally, a word on terminology, which also has a substantive implication. In our view, all surveillance operations which come to the Board are the exercise of multilateral surveillance. A country is being assessed by its peers. The paper appears to acknowledge this accidentally by characterizing the country matters sessions as both multilateral (paragraph 21) and bilateral (paragraph 22). The key point is that surveillance is not multilateral just because it comes out of the Research Department and bilateral just because it comes out of an Area Department. There should be a continuum, so that the Area Departments look to the work of the Research Department (and, as appropriate, MAE, PDR and FAD) as operationally relevant in conducting Article IV discussions and drawing up the subsequent reports.

Mr. Taylor and Mr. Woolford submitted the following statement:

Overall, we are comfortable that the Fund's surveillance is moving in the right direction and welcome many of the developments identified in this review. We must continue with our efforts, paying particular attention to the implications for Fund surveillance of the evolving architecture. We also need to re-think how we might better tailor our surveillance efforts to fit the needs of our disparate membership.

There continues to be a significant challenge facing the Fund in terms of its ability to adapt and enhance surveillance, taking into consideration the lessons of the Asian crisis, without placing further strain on limited resources. We believe that the Fund will need to tailor its approach to the surveillance of countries to more closely reflect their individual situation and characteristics and exercise judgement on the issues to be covered on a case by case basis. And, as always, we need to constantly look for more efficient ways of working.

CONSULTATION FREQUENCY

Remembering that Article IV consultations are but one part of an increasingly complex surveillance agenda, we support a move to less frequent consultation cycles for some countries—in particular we see merit in moving to an 18-24 month cycle for countries with a clearly established track record of sound policies. This would be by election, and it would be on the basis that members would still be able to call on the Fund for advice when issues of macroeconomic importance arise between consultations, and there are interim contacts, including via greater use of telecommunications.

This, we believe, would provide for more effective and efficient surveillance than the present standardized practice.

To the contrary, the Fund's smallest members should be encouraged, not discouraged, to have frequent policy contact with the Fund. Small more frequent missions, by staff who are able to build knowledge of the peculiarities of small economies and intercept policy drift in a more timely fashion, would be a better model. In fact, perhaps consideration could be given to placing a policy person with the technical PFTAC experts.

Despite the preference expressed in the Interim Committee Spring 1998 Communiqué and in the external evaluators' report to investigate new forms of joint collaboration, and therefore avoid duplication of effort, there is little discussion in the paper as to how the burden of surveillance activities could be shared with other institutions.

Surveillance of Exchange Rate Policies

While the Fund's work in this area has developed strongly, we believe greater acknowledgement that no one exchange rate regime is appropriate to all countries is still required.

COVERAGE OF NON-CORE" ISSUES IN BILATERAL SURVEILLANCE

We believe that the macroeconomic impact criteria allows a substantial degree of flexibility, and would seem to be the most appropriate means to assess which "non-core" issues to cover.

Experiences from the Asian crisis indicated the role structural factors could play in influencing a country's macroeconomic situation. However, we stress that the Fund does not have the mandate, resources or expertise to cover a wide range of "non-core" issues. As such, we would oppose any moves to systematically include assessments of "non-core" issues such as social policy instruments, military spending and the like in Fund surveillance. Where these issues are considered important we would prefer to see consideration given to contracting them out to other international financial institutions.

REGIONAL SURVEILLANCE

The Fund has an important contribution to make in supporting regional surveillance activities. In both the Manila Framework Group and Asia Pacific Economic Cooperation (APEC) Finance Ministers meetings, the Fund has contributed usefully to discussions by providing an overview of developments and risks in the region and helping place them in a global context.

We feel however that the Fund could better tailor its product for different audiences (a strong emphasis on macroeconomic issues and in particular risks, vulnerabilities and emerging imbalances is appropriate for the Manila Framework Group context. For APEC, there should be a greater emphasis on structural issues (e.g. corporate and financial sector restructuring) which are more the focus of APEC's collaborative working group culture.

World Economic Outlook

Significant improvements have been made in multilateral surveillance reporting by the IMF over the past two years – with the increased focus on capital account and financial market developments a notable improvement (particularly the importance of capital flows in emerging markets). Similarly bringing together the work on vulnerability indicators with the ongoing surveillance work has improved the ability to make risk assessments. One suggestion would be to explore the extent to which it is possible for the IMF to provide some weighted risk assessments – that is, indicating whether something was a high/low probability outcome, but would have a high/low impact would help put risks into context (we would encourage a qualitative rather than overly scientific approach.

Vulnerability Analysis in surveillance

While we are generally supportive of the benefits of transparency, we cannot be blind to some of the risks in the public disclosures of some information, particularly that dealing with country vulnerability. We believe a country's desire for confidentiality should be respected, and are mindful of the possibility of precipitating a crisis through insensitive publication of Fund assessments and country comparisons. A balance also needs to be struck between identifying clearly defined vulnerabilities and those of a more abstract nature.

While we will need to reflect on the matter further, Mr. Wijnholds's 'proposal 5' on separating the discussion on vulnerability from the standard Article IV, by way of a supplement, seems sensible.

On box 17 and the associated text we have two related comments:

In the view of our New Zealand authorities, Box 17 and the related text on page 57 does not fully capture the difficulties associated with using EWS-type indicators and models for developed countries. In fact, they believe that the case of New Zealand highlights that EWS indicators and models may be irrelevant for developed economies with floating exchange rates such as New Zealand. This suggests that EWS should not be incorporated systematically in Fund bilateral surveillance, and they should be interpreted very cautiously, with early recognition of possible mitigating factors. The emphasis should be on understanding vulnerabilities, rather than strictly adhering to a quantitative model. In this regard, we find the box a little glib, in the sense that the EWS set the alarm bells ringing—but it was careful analysis and an understanding of the country-specific factors that laid the concern to rest. Maybe, the EWS is an inappropriate tool in the case of New Zealand. (The authorities have more detailed comments that which we will pass onto staff bilaterally.)

My Australian authorities have concerns about adoption of a balance sheet management approach to a country's external liabilities. They see such an approach as likely to provide misleading signals about a country's vulnerability when that country maintains a floating rate regime, has access to global capital markets and a sound economic policy framework. If the IMF is to develop a set of best practices for external debt/liquidity management, they would wish it to take account of the overall risk exposure of the economy, including the extent of hedging exchange rate exposures in economies with floating exchange rates. In addition, rather than focus on rules to contain the amount of short-term debt, which may flow out of a country and precipitate a crisis, they would prefer the approach of managing capital outflow by improving risk assessment by investors before the crisis emerges. Should a crisis occur, however, the approach should include bailing in existing debtors through standfasts, restructuring or other mechanisms.

Of course, this last issue will be discussed at a Board seminar in the near future and we can come back to this issue then.

COMMENTS ON OUTPUT GAPS AND FUND POLICY ADVICE

This section struck us as a curious way of testing the criticism of 'one-size-fits-all'. Wouldn't a more revealing test be an examination of privatization recommendations (which is a near standard recommendation by the Fund), or the "It's Mainly Fiscal" criticisms.

A criticism voiced through the external evaluators of the Fund's tendency to produce a one-size-fits-all-approach was rejected in the paper, using analysis of monetary policy prescriptions. We remain concerned, however, that the IMF has yet to mirror some shift in opinion towards acceptance of restrictions, including "standfasts", on capital outflows in times of crisis.

Notwithstanding these reservations, another issue worth noting is that of bias in the IMF's measure of the output gap. Rather than "looking at the sign" as mentioned on page 22 of the Biennial Review, an alternative approach would be to compare the IMF's measures to other agencies. Such a comparison could provide helpful information to both parties, as to whether one measure is consistently below or above the other. It is also worth keeping in mind the method of calculation of the output gap is critically to be important for any inference regarding the output gap. Any policy recommendation that is based on the size of the output gap, whether indirectly or directly, must be made with the limitations of the data in mind.

Mr. Shaalan said that, as most chairs had commented on the issue of core and noncore activities, he wished to clarify his position on the subject. While there were noncore issues that could be directly relevant for macroeconomic stability and growth, it did not follow that the Fund should be involved in the assessment of, and engage in, policy recommendations to address, for instance, labor issues. The Fund should rely on other institutions with the requisite expertise such as, in this case, possibly the OECD for the industrial countries, and possibly the ILO. Moreover, many of these countries were advanced enough that they already had serious studies on these problems, which should serve as an input into the work of the appropriate organizations with the requisite expertise. That being the case, it was extremely difficult to accept the argument that an issue became a core issue only because it was relevant to a particular country, and therefore the Fund needed to carry out the necessary work. It was very important that the Fund's thinking be advanced on the subject as suggested in many statements. Clear guidance must be provided to the staff on what were core issues, and the need for including noncore must be made amply clear in the report. It was also important to make a conscious effort to reverse the current trend of mission creep.

On vulnerability indicators and early warning systems, Mr. Shaalan considered that it was widely accepted that more work needed to be done in those two areas before their publication could be contemplated. Their predictive value had not been useful; in fact, in previous Board discussions, the point had been made that they could be counterproductive if published. Having said that, such issues should be discussed with the members, where it was relevant, in the context of surveillance. However, like a number of other Directors, he would exercise extreme caution in their publication either within the Article IV process, or as a separate annex outside the Article IV consultation report.

Mr. Chelsky said that he agreed with Mr. Kapteijn's comments on the core/noncore issue. It was important for the staff to explain explicitly why certain issues were being raised if they were considered to be noncore. In response to Mr. Shaalan's remarks on the matter, it would not seem appropriate to take a too narrow and rigid view of what is core and noncore, and hence what should be covered by other institutions. To the extent that the Fund's goal was to give the members the best analysis and policy advice, it would appear necessary to show some flexibility. In such cases, it was important to consider the degree of the Fund's involvement. For example, simply because the Fund acknowledged in a particular case that environmental concerns were a serious impediment to medium-term balance of payments sustainability, did not mean that the staff needed to write papers about how one could improve, for instance, forest management. Clearly, the Fund should not replicate the work of other, more experienced institutions; rather, their work would need to be incorporated into the Fund's consideration of such issues. On such issues, judgement would need to be exercised to consider matters in a flexible manner. Moreover, there were some issues—such as governance—where expertise did not clearly reside in any single institution. Indeed, governance issues should be regarded as core to the Fund's mandate, as they dealt with how to assess the quality of the information provided to the Fund and whether a country possessed the institutional capacity to implement agreed policies, such as prudent expenditure management.

The Deputy Director of the Policy Development and Review Department said that he wished to address some of the broader issues that had been raised by Directors in their preliminary statements. The first broad question that arose in a number of the statements—most forcefully perhaps in Mr. Kelkar's and Mr. Collins/ Mr. Burgess's, and Mr. Bernes/ Mr. Chelsky's—was how all the various issues fit together and what was the aim of the staff. Was it to respond to the external evaluation? Was it trying to take stock of surveillance practices and point out deviations from past guidelines? Or was it trying to present some sort of vision for what surveillance should be in the future?

The first broad issue was to address matters that had been specifically raised in the summing up of the Board discussion of the external evaluation, the Deputy Director stated. These issues included the focus of surveillance, increased attention to cross-country and regional issues, and vulnerability in early warning systems. The objective had been to reassess the points made by the external evaluators—on which there had not been complete agreement and concurrence—and to address those on a more systematic basis. This was necessary before arriving at any kind of action plan on surveillance. So, the paper sought to present the evidence candidly on all of these issues and to afford the Board a chance to assess policy in these areas on the basis of the evidence. It was true that, as a number of the statements pointed out, the large amount of statistics presented in the many tables could have been rendered more palatable by additional commentary and qualitative analysis, but the staff had eschewed that path in favor of simply presenting Directors with the facts.

The second broad point to be raised was that there was a whole set of issues in the external evaluation exercise and in the surveillance area that were not covered in the staff paper, as there was much work that was ongoing, the Deputy Director continued. Box 3 in the paper outlined the work program on surveillance-related issues, which included work on the FSAP process, data standards and codes, debt and reserve-related vulnerability indicators, and transparency. Clearly, the current staff paper could only be seen as an interim report, because it was not possible to anticipate the outcome of the Board discussions on such matters. The staff would need to prepare a follow-up report that incorporated the conclusions of discussions on these related issues. The current staff paper did identify some of the areas where Fund surveillance could be improved. For example, the paper was quite candid in finding gaps in how the Fund conducted financial sector surveillance. Another example was the coverage of a number of indicators, such as nonperforming loans, maturity transformation, foreign exchange and foreign exchange derivative positions, and sectoral credit exposure. In such areas, it would be important to rely on the conclusions of the FSAP process that would then feed into the surveillance.

A third broad point to be made is that there was an implicit recognition that surveillance would have to draw on outside expertise, which underlined the evolving vision of surveillance, the Deputy Director said. For example, work on corporate vulnerability was being done by the World Bank, and the Bank was involved with the Fund in the FSAP process. Indeed, much work would be done under various headings and by various institutions, whether it was the BIS on external debt or banking, or the Bank on poverty. Where there were findings from that work that were seen to be of critical, significant macroeconomic relevance, they would be filtered into the Fund surveillance process and hence into the policy advice provided to countries by the Fund. While that was the broad vision underlining such diverse work, the Board would have to assess whether that was a realistic action plan. Clearly, some experimentation would be needed to test it, and there would be problems of coordination between the Fund and other institutions, given the differing work practices and timetables.

Moving to more specific issues, the Deputy Director noted that the question of what were core and noncore issues for Fund surveillance had been commented by many Directors, although the guidance from the statements was less than clear-cut. Some Directors—such as Mr. Shaalan, Mr. Wijnholds, Mr. Kelkar, and Mrs. Hetrakul—expressed a preference for very strict limits—not just the macroeconomic relevance test, but direct and substantial macroeconomic relevance. However, Mr. Bernes and Mr. Chelsky viewed the matter as a moving target, and observed that it was difficult to define generally what constituted core issues. Ms. Lissakers and Mr. Sobel wanted a broadening of surveillance to cover all segments of society, and they noted that, "enhancing rates of return on health and education spending," was part of the Fund's mandate. However, Mrs. Hetrakul and Mrs. Vongthieres said that "health care and social issues are not in the domain of the Fund."

It was unfortunate that Mr. Bernes and Mr. Chelsky had dismissed the staff's view that too many different tasks were being added to surveillance, the Deputy Director remarked. While they considered that the focus should be on whatever was important, that was a difficult policy to implement in practice. Indeed, it would become necessary to find staff with expertise in many diverse areas within a typical mission team of four or five economists. Recent examples included areas such as the central bank's foreign exchange options pricing, and the hedging related to that, the loan concentration of nonbank financial intermediaries, the relative corporate vulnerability to interest rate changes and exchange rate changes, and many diverse problems in the insurance industry. Mission chiefs were scrambling to find the expertise on such issues, in order to ensure that critical issues were not overlooked.

Mr. Chelsky considered that there was another side to the matter raised by the Deputy Director of the Policy Development and Review Department. For example, in discussions on

Kenya about three years ago, it had not been easy to undertake a substantive discussion of governance issues that had been critical to its economy. Similarly, there appeared to be difficulties in discussing the astounding HIV infection rates that clearly were going to have a significant impact on that country's fiscal situation and its labor supply. Such issues were clearly relevant in that particular case. While it was true that there were some issues that might not be extremely clear and that there were resource constraints, it was often not difficult to identify in particular cases the specific issues—which might traditionally be noncore issues—that were of critical macroeconomic importance to that country. Other recent examples included the environment in Uzbekistan and military spending in Myanmar.

The Deputy Director of the Policy Development and Review Department suggested that he could take up the matter on a bilateral basis with Mr. Chelsky after the current meeting.

On Mr. Wijnholds's proposals, the idea to consolidate all guidance notes into a single manual would be useful, the Deputy Director continued. The idea could be implemented as soon as there was agreement on the substance. The manual, along with perhaps Mr. Wijnholds's excellent statement, could be posted on the Fund's internal web page so as to be available to all staff—particularly mission chiefs—at all times. On Mr. Wijnholds's proposal for the staff to present highly confidential vulnerability supplements to staff reports, in which unpublishable sensitive material can be conveyed to the Board, the matter raised some awkward questions—such as whether there was a limit to the degree of transparency that the institution could bear and whether, in the event that it became policy to publish Article IV staff reports, some other vehicle for candid assessments was needed. Clearly, such questions would need to be considered carefully in the context of the upcoming reviews of the pilot project on the release of Article IV staff reports and other transparency initiatives.

On Mr. Wijnholds's suggestion that staff missions should be scheduled so as to maximize their effectiveness on the domestic policy agenda, for example to coincide with the budget cycle. While that was a good idea, it conflicted with the positions expressed by a number of other Directors that consultations be scheduled in a way that was sensitive to the Board agenda. Some consideration would be required to try to harmonize the two sides.

On the issue of output gaps, which generated much interest among Directors, the Deputy Director said that the staff had examined the issue only because it had been specifically raised in the discussion of the external evaluation, not because that was the definitive way of analyzing whether there was a conservative or a liberal bias in projections. The section of the paper was replete with caveats and it did not purport to be a comprehensive study. Ms. Lissakers and Mr. Sobel addressed staff errors in the assessment of the spare capacity; the staff was equally frustrated by the need for such revisions, but it had to be recognized that assessments of most observers were imperfect. In response to Mr. Faini's question of whether such calculations were of any use, it would be difficult to do without them, as macroeconomic assessment required some view of potential output and spare capacity, which were needed to project inflation and to determine what was cyclical and what was structural in the budget deficit. In the past, such assessments had been made by looking at capacity utilization in manufacturing, but the share of manufacturing of overall economic activity has become too small to make inferences regarding the broader economy. The NAIRU could be used, but this indicator had the same sorts of problems as the measurement of the output gap. Thus, staff reports would continue to include an assessment of potential output and where the economy was relative to that potential, and it was preferable that that assessment be explicit rather implicit—even if that meant an inevitable degree of error.

In response to a question from Mr. Bernes and Mr. Chelsky, the Deputy Director considered that the concept of the output gap was meaningful for an economy as small as the Netherlands. It might be true that, in a very open economy, there would be an infinitely elastic supply of traded goods, but certainly an inelastic supply of nontraded goods. For example, in the Netherlands, the housing prices had been rising at about 15 percent a year, and the stock of mortgage credit had risen as a percentage of disposable income. In such circumstances, it would be important to consider spare capacity, overheating, and the ramifications for other things like bank portfolios.

Mr. Faini pointed out that his comments on the issue of output gaps had been meant to be constructive. He had not suggested that an assessment of an economy's output gap was of no use. Rather, he had tried to put the matter in some larger context, by asking whether the different measures of output gaps were a good predictor of inflation. The second question he had posed was how useful was the output gap concept in the context of small, open economies, which were open to factor flows such as immigration and capital inflows. In such cases, the potential output gap concept could be seen as endogenous, rather than exogenous.

Mr. Chelsky remarked that his statement had also been meant to be constructive in nature. In raising issues that needed to be addressed further, he was recognizing that more work needed to be done on the output gap concept. His statement had not meant to be critical of the staff's efforts, but rather a recognition of the complexity of the matter.

Ms. Lissakers said that, on the question of core and noncore issues, she agreed with those who said that it was not possible to draw a neat line between what was core and noncore. The matter was more a question of a hierarchy of concerns, and the hierarchy of concerns for the Fund was different than the hierarchy of concerns for the Bank, for example. As one descended down the hierarchy, there would be some overlapping of the concerns and some disagreement about where one institution's hierarchy ended and where another's began. The hierarchy would also vary from country to country, as other Directors had said. While some things were more important core issues for certain countries than for others, all Directors would agree that at the top of the hierarchy for the Fund was the question of external vulnerability, and the potential for serious balance of payments disequilibria. During her time on the Board, it had appeared to her that, until very recently, the hierarchy of concerns had been turned on its head. It had been the exception rather than the rule in Article IV consultations when the consultation had led with the balance of payments picture and the potential for disruption. That message seemed to be shared by other Directors, who agreed that, in Article IV consultations, there should be an explicit link to a discussion about the balance of payments situation, particularly about any vulnerabilities, as that was the primary objective of the Fund's surveillance exercise. It was essential to anticipate and try to prevent balance of payments disruptions, and particularly helping countries to avoid such problems. Clearly, there were a number of important missions for the Fund, including helping countries to achieve high-quality growth and to reduce unemployment, and advising countries on how to manage long-term social security. However, such issues should not be done at the expense of the Fund's first mission—to try to identify balance of payments vulnerabilities and the potential for disruption which was damaging to the global economy.

Mr. Yoshimura said that he agreed with Ms. Lissakers said on the matter of core and noncore issues; ensuring sound balance of payments and external viability was of paramount importance to Fund surveillance. However, the use of the term hierarchy was inadvisable, as it suggested that all issues would be covered; it was better to retain the distinction between core and noncore issues. At the core of the Fund's mandate must remain the fundamental mission or purpose of the institution—issues relating to the balance of payments, foreign exchange, the macroeconomic situation, and financial sector issues. There were noncore issues that could be important in particular countries—such as governance and military expenditures—but they must be covered as noncore issues, and not as universal issues.

Mr. Collins considered that there was not as much disagreement on the core/noncore distinction than appeared on the surface, but there might be a misperception over what was expected of the staff when confronted with an issue of macroeconomic relevance to a country which was noncore or nontraditional. It seemed that Ms. Lissakers's idea of a hierarchy was appropriate, in the sense that every Article IV consultation ought to look at the basic key macroeconomic issues, such as the exchange rate, that was required in the Articles. And, increasingly, further focus should be devoted to assessing vulnerabilities. However, the staff should also diagnose any other issues that had important macroeconomic relevance to a country—much like a doctor or an internist, whose job it was to spot the systemic things that put a patient at risk, but not necessarily be able to deal with all of them, but to know to whom to send the patient for treatment. Indeed, that related to Mr. Shaalan's concern that somehow the staff had to develop expertise in all areas. In some areas, it ought to be the expert, because there was no other expert; in other areas, the staff ought to recognize that there were macroeconomic consequences if the issue was ignored, but attention should be drawn to the matter in the staff report, but the issue should be dealt with by the appropriate institution. It was true that there were some issues, like corporate governance, where it was difficult to identify an expert. However, there appeared to be broad agreement that the staff must be expected to identify anything of important macroeconomic relevance. Those issues should be included in the staff report and attention should be drawn to the risks arising from the problem. Thus, in so-called noncore areas, the staff should have sufficient knowledge to know when to refer the matter to the appropriate institution, and then be able to react to any future recommendations from that body.

Mr. Junguito said that he agreed with those speakers that said that noncore issues should be addressed only when they had a direct and substantial macroeconomic relevance. The staff would have to justify why that particular noncore issue was exceptional and very important for the macroeconomic stability of the particular country—and not only, as Mr. Collins said, all areas that may have macroeconomic relevance.

Mr. Mirakhor said that it was important to focus the current discussion in order to provide clear guidance to the staff. The essential question facing the Board was not as simple as some Directors considered. From an operational standpoint, there were the two ends of the spectrum being considered. One was a rules-based approach, where the Board specified the core areas, and then the second was that there would be a litmus test for a strong macroeconomic relevance. However, the two elements were not necessarily compatible, because the rules-based approach was generally applicable, whereas the second element pertained to country-specific matters, which required judgment on the part of the staff and the provision of a justification to the Board of why such a decision had been made. However, that would place the Board in difficult situation, as it would contravene the most important principle of the institution—uniformity of treatment. There already appeared to be some tension in some of the Article IV consultations and some program papers that came to the Board, in which the staff took positions on issues like military spending and tariffs, and then the Board was forced to take either a benign position on some, or actually a contrary position on the other. Caution needed to be exercised as to what guidance would be sent to the staff. In that context, Mr. Collins's analogy of a doctor was inappropriate, as there did not appear to be any doctor who could diagnose a specific illness without the required expertise. Thus, it was important for the Board to reach a consensus on the matter in order to provide the staff with clear guidance.

Mr. Faini considered that, as cautioned by the Deputy Director of the Policy Development and Review Department, Directors should not underestimate the difficult choices that the staff had to make in the field—especially in areas such as the financial sector for which they often did not yet have sufficient expertise.

The current discussion, while useful, had neglected the question of how the Fund should deal with noncore areas that had macroeconomic relevance, Mr. Faini continued. He considered that such issues should not be simply appended to the Article IV staff report, but should be more fully integrated into the body of staff reports. For example, the issue of poverty should not be treated merely in a box, but should be integrated into the main analysis and recommendations.

Mr. Taylor said that he agreed with a number of points made by different Directors. For example, he agreed with Ms. Lissakers that there was a hierarchy of concerns, and that the balance of payments and the exchange rate are at the top. He also agreed with Mr. Bernes and Mr. Chelsky that such a hierarchy would arise in different ways in different places. For example, in the last Article IV report on Kiribati, the staff had pointed to the problem of lagoon pollution, which could threaten the balance of payments because it might kill all the fish, which was the only economic asset the country had, apart from its well-managed trust fund. Thus, he would agree with Mr. Collins that the focus should depend on the particular circumstances. While every issue could not be addressed, it was important to identify the problems.

The Deputy Director of the Policy Development and Review remarked that Ms. Lissakers was correct in saying that there was no disagreement that, at the apex of the hierarchy, were issues relating to the balance of payments and currency crisis vulnerability.

Where there appeared to be some disagreement was lower down the hierarchy of issues. In such a case, the surveillance process could be strengthened by bringing in outside expertise. The findings of those external experts, along with the expertise throughout the Fund, would funnel into the surveillance process through the fine filter of macroeconomic relevance. The question would then be whether the required coordination be overwhelming.

The Deputy Director of the Research Department, in response to questions and comments from Executive Directors, made the following remarks:

> Most Directors feel there should be closer links between the Fund's multilateral and bilateral surveillance activities. I could, of course, simply reply on this question by arguing, as one Director did, that this is essentially a question of terminology. But, I think the concerns that have been raised go beyond terminology. And it is, of course, flattering for the Research Department and Mr. Mussa that Directors would like to see more references and more use in the Article IV consultation reports of the analysis carried out in the WEO and the international capital markets report.
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> At the same time, I think we should distinguish between the explicit references that are being made, and the very extensive cross fertilization of ideas that takes place constantly across departments. And I think the Directors who are calling for greater contacts across departments and greater coordination, do not do justice to this extensive cross fertilization. We do have extensive contacts, ongoing meetings to view the forecast, to discuss the risks, to discuss alternative scenarios, alternative assumptions. We exchange views on the exchange rate analysis, in particular, especially for the industrial countries, but increasingly, also, beyond the industrial countries to make sure that what we say about exchange rates is being done in a multilateral context and is consistent across countries. We discuss alternative scenarios and forecast assumptions, for which there is a bit more difficulty, because at the end of the day, the individual forecasters in area departments have the final word in terms of the specific assumptions that are being adopted. But I do think that the Research Department plays a role in trying to draw attention when serious inconsistencies arise in the global picture, and then try to resolve them through interdepartmental meetings and negotiations. We also have extensive cross fertilization on many analytical issues, as Directors have mentioned in their statements; the early warning indicator system was initially developed in the Research Department, and there is an ongoing cooperation with the Research Department when individual desks are trying to develop early warning indicators for individual countries, and for that matter, also, when some individual countries are requesting the Fund's assistance in trying to develop a system for their own use.
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> A more recent example includes the extensive work we have done on the importance of asset prices in policy formulation. The importance of asset prices for the business cycle is discussed extensively in the current WEO, which will be discussed by the Board the week after next. And, I have had a number of

expressions of interest from colleagues in area departments which suggest that similar analysis applied to country-specific cases can be expected to appear in Article IV consultation reports during the period ahead.

The analysis of output gaps is another important example where the conceptual framework has been developed over the years both by the Research Department and by many individual desks. We have tried to have a reasonably consistent approach, but given the uncertainties there are in the estimation of output gaps and potential output, we have at the same time been able to accommodate a variety of specific approaches.

On this issue, given the uncertainties, one should be very careful not to pin an important policy recommendation exclusively on the calculation of potential output and of the output gap. Generally, many other considerations are being taken into account. At the same time, the proposed gap is a very useful, if not indispensable, indicator that allows the staff to have a consistent view of the current and near-term situation of the economy, and of the medium-term output path consistent with low and stable inflation.

Mr. Faini asked specifically whether the output gap is a good predictor of inflation. The answer is clearly no, if he thinks of the level of inflation. At the same time, without having looked recently at the evidence, I am quite confident that the output gap must be a good measure of changes in the rate of inflation for the reason that that is one of the key criteria being used to define the level of potential output which can be defined as the level of output that is sustainable without acceleration or deceleration in the rate of inflation. There must be a close relationship. As I said, I have not looked at the evidence recently, and perhaps it is an area to come back to. But I am quite confident that the evidence will confirm what I indicated.

On a couple of specific issues raised by Executive Directors, Mr. Kelkar suggested that there should be more emphasis on trade issues in general and specifically he referred to the work done by the WTO. The staff very much agrees with that, and we do occasionally include fairly significant pieces of analysis on trade issues in the WEO, for example. Where I think I would be less in agreement is the suggestion that we should do this on a regular basis, if Mr. Kelkar has in mind that we should review trade issues for some special chapter in each and every WEO. There would not be enough new things happening in the trade area to warrant a regular chapter on trade issues. But we should definitely do it whenever there are important new issues to raise. I believe we have done so in the past and will continue to do so in the future.

Mr. Wijnholds raises a rather delicate issue about the availability of the so-called surveillance note, which the staff produces occasionally for the G-7 Deputies first and subsequently for G-7 Ministers. I do have considerable sympathy with Mr. Wijnholds's request. At the same time, I would caution that these notes are being requested on an ad hoc basis, in each and every instance it is at the initiative of the G-7 themselves to request a note from the staff. Over the years, and this started in the mid-to-late 1980s, this has become more and more regular. Over the years, the G-7 has become very comfortable asking the Fund for this service. I presume because they find the analysis to be interesting and a useful basis for their discussions, but also because they have been confident that the staff would treat this on an extremely confidential basis. And in turn, of course, they have also, I believe, made considerable efforts, and very successfully so, to ensure that this note is being kept confidential, also, in national administrations, and I believe that the experience is that the note has never been leaked. So, I think in considering how to deal with this issue, I think it is important that we do not jeopardize the relationship, the privileged status of the Fund as an interlocutor when the G-7 meets to discuss surveillance issues, and also as an informal secretariat that contributes these notes.

The truth is, of course, that the notes, while they may differ in candor from some of the other things that are produced in writing, do not really contain much in terms of policy analysis and views on exchange rates that is fundamentally different from what you read in other Fund documents—and certainly from what you hear in the World Economic and Market Developments sessions.

All of this being said, I think this is perhaps an issue where the staff and management might consult with the G-7 Executive Directors or Deputies to get their views on whether and under which modalities they would be prepared to make their notes available on a broader basis.

Mr. Kapteijn said that it was his recollection that, at the previous discussion of the work program, it had been decided that such notes to all fora would be distributed to the Board. If such notes were confidential, then they must contain pertinent information for Directors, and should be shared in the context of multilateral surveillance.

The Secretary clarified that, at the end of the work program discussion, he had said that the information and notes that were prepared for a variety of bodies could be distributed to the Board. However, he had understood that the focus of Directors' attention had been on the information provided to the Financial Stability Form and the G-20. Moreover, it was important to recognize the special factors highlighted by the Deputy Director of the Research Department with respect to the surveillance notes prepared for the G-7.

The Acting Chairman considered that the issue raised by Mr. Kapteijn was complicated, because if the staff could not provide such notes on a confidential basis, then it was likely that such information would be requested from another body—something that would hurt the Fund's ability to improve its links with, and surveillance of, G-7 countries. In addition, it might discourage other groups and countries that could occasionally request such information from the Fund. Thus, while the Board had the right, in principle, to request to see every confidential communication that was sent to a country, the matter required careful consideration, as such a policy, in practice, would likely reduce the role of the Fund in such countries.

Mr. Mirakhor said that he agreed with the Acting Chairman. It was important to recall that such notes were one channel of the Fund's surveillance; thus, the confidentiality of discussions with the G-7 should be respected. In fact, the more the possibility and existence of channels of surveillance with the G-7, the better off the Fund and the world economy would be. Indeed, one of the factors identified by the external evaluators was the fact that the Fund had little influence on the policies of G-7 countries. That asymmetry of surveillance had always been a concern of developing countries, so anything that might weaken that influence over G-7 countries should be avoided.

Ms. Lissakers said that she agreed with the Acting Chairman that the matter was not a simple issue and required further consideration. On the principle, Mr. Wijnholds was undoubtedly right. On the other hand, the G-7—as well as the other groups for which the Fund produced surveillance notes, such as the Gulf Cooperation Council and APEC—valued the information and treated it discretely. Thus, there could be a reduction in the value of the Fund's contribution.

Mr. Yoshimura agreed that the matter was complex, but it was important to emphasize the benefit of such an exercise to the Fund. The Managing Director was invited to participate in the G-7 surveillance discussion, and such an opportunity should not be lost because of a somewhat procedural point.

Mr. Kiekens said that he had always recognized that there was a delicate balance between confidentiality and transparency—transparency to the Board and transparency to the public. In preliminary discussions with the staff in the runup to the pilot project on the release of Article IV staff reports, it had become clear to him that, if publication went too far, then countries might call on other bodies to provide them with confidential advice—a conclusion that most speakers seemed to have drawn with respect to the G-7 surveillance notes. On the question of where to draw the line between transparency and confidentiality, the answer would seem to be that, in trying to strike the right balance, one would consider the consistency of a particular advice which remained confidential with the more general advice and discussions that emanate from the Board. He would agree with the Deputy Director of the Research Department that the individual G-7 notes, which were considered very confidential, were fully in line with what the Board and the staff discussed in the context of the WEO and the WEMD sessions. As such, he would consider the process as acceptable. However, if such notes were inconsistent with the general policy recommendations agreed in the Board, then the process would need to be reconsidered. Finally, it was clear that, if the staff provided opinions and advice to a group like the G-7, that was part and parcel of the consultation mandate of the Fund, and the consistency of that individual advice with what was disclosed and discussed with the Board on a more general basis was essential.

The Acting Chairman remarked that he had never seen a G-7 note that departed substantially from what was said in the WEO. The G-7 had expressed a preference, nevertheless, to maintain confidentiality. Also, Ms. Lissakers was correct in pointing out that such confidential documents had been provided to other groups, such as the Gulf Cooperation Council, the Western Hemisphere Ministers of Finance, and APEC. In one case, the documents had been published ex post.

Mr. Esdar said that he agreed with the Acting Chairman that the G-7 notes had not varied significantly with what was contained in the WEO. The notes had more of the character of speaking notes for the Managing Director. Similarly, in the context of the Article IV discussions with the authorities, a preliminary note was provided to the authorities outlining the main topics. In that context, it would not occur to anyone to publish such a note. It should be regarded as a step in the multilateral surveillance process.

The Acting Chairman remarked that Messrs. Esdar and Mirakhor were correct to say that such an exercise was part of the surveillance process, and there was feedback that eventually fed into the WEO in particular. Clearly, there were a number of complex issues that required further consideration.

The staff representative from the Policy Development and Review Department, in response to questions from Executive Directors, made the following remarks:

> I will respond to some specific questions raised in preliminary statements. Mr. Kelkar wondered why the treatment of real effective exchange rates of developing countries in the staff reports analyzed had fallen from 48 percent to 40 percent from 1997 to 1999. Let me first say that in our careful reading of the reports, we identified an overall improvement in the coverage of exchange rate issues for developing countries. To put the drop in the coverage of real effective exchange rates in perspective, we can look at the previous year 1998 where we had seen an improvement as compared to 1997, meaning an increase in coverage. So basically what we observed is in the aftermath of the Asian crisis there was a concerted effort to strengthen our analysis on exchange rates. We saw that improvement fall off as conditions may have settled, and thus you see the drop in 1999. In terms of a concrete explanation for the drop, we are basically asking ourselves the same question. But in this regard, you will see that we have also suggested that in good times, we would still need to focus or maintain the same type of effort in focusing on these issues.
>
> Mr. Kelkar also wondered whether we could comment on our observation that half of the reports surveyed had discussed issues relating to macroeconomic consequences of capital flows. Again, in looking over the period, what we saw was an actual improvement in the coverage of these issues in staff reports, on average. However, as we note in the summary box to this section, we did see areas for improvement, and these areas included discussion of the linkages of changes or movements in capital flows to the general macroeconomic environment, as well as to the financial sector.
>
> There was concern expressed by Mr. Yoshimura and Mr. Oyarzabal about the increase in delays in consultation cycles, and they wondered what we might be doing about that. One answer would be to provide data or information

to the Board on cumulative delays. We now circulate a report monthly on delays. One suggestion would be that when you review that report, if you see an indication of extended delays in particular cases, that you note and question that observation.

Mr. Taylor remarked that the issue of output gaps had been put forward in the staff paper as a means of testing the question of whether Fund policy advice was biased toward macroeconomic tightening. However, that test only applied to industrial countries. As the summing up of the discussion on the Fund-supported programs in the Asian crisis noted, "...some Directors questioned the appropriateness of fiscal restraint in the first instance, and the general view was that programs' original fiscal targets now appear to have been tighter than necessary." He wondered whether anything could be said beyond the industrial countries about the assertion of bias; if nothing could be said at the current stage, then care must be exercised in any summing up on what could be concluded.

On exchange rates, Mr. Taylor stated that in about 40 percent of cases, the staff had expressed reservations or concerns about either exchange rate regimes or the level of the exchange rate, or both in developing countries. That suggested that some further study of such cases might be desirable, and one of the conclusions from the staff paper seemed to suggest that there was much unfinished business in that area.

Several Directors had raised the question of frequency of Article IV consultations; Mr. Taylor invited the staff to comment on the matter.

Mr. Faini remarked that, on resources-related issues, the staff mentioned that in the last few years, the average interval since the last consultation had increased, about which they expressed some concern. However, it was important to recall that the increase in the interval reflected the fact that many countries had moved from the one-year cycle to the two-year cycle. Unfortunately, there were no data on the average interval for countries that had stayed on the one-year cycle. Also, it was striking to note Table 10 that indicated the increase in the work load for the Board—about a 25 percent increase.

Ms. Lissakers wondered whether the staff had considered a much more radical change in the Article IV process, namely eliminating or reducing the frequency of the standard comprehensive consultation. Instead, there could be continuous surveillance on an off-site basis, such as through telecommunications with the authorities and the monitoring of key data on external vulnerabilities, and then there could be a standard consultation in direct contact with the authorities every two years.

The Deputy Director of the Research Department said that, with respect to Mr. Taylor's question on the issue of bias, care must be exercised so as not to try to define as bias a relationship that might apply for a small group of countries during a particular period. The analysis done in the staff paper on the industrial countries had not been applied to a larger group of developing countries, primarily because the issue of the role of the output gap and policy formulation became quite different if one considered a financially constrained country, where fiscal policy was being used to attempt to close an external payments gap. In such a case, such an analysis did not seem appropriate. For example, in the case of a crisis that was provoked by an external payments imbalance, reinforced by a fiscal imbalance, the policy advice would typically include the need to tighten fiscal policy, even though there might be a large and widening output gap.

The Acting Chairman remarked that Mr. Taylor was correct in saying that there did not appear to be an appropriate evaluation of that point. At the same time, the Deputy Director of the Research Department's point was also valid, as the output gap was not the only indicator of whether fiscal policy needed to be tightened—that might be needed for balance of payments reasons. Perhaps such issues relating to the output gap could be reviewed in the context of a future evaluation of surveillance.

The Deputy Director of the Policy Development and Review Department reiterated that the staff paper had not tested possible Fund policy biases for all countries in all respects; rather, it had been a partial test in response to the discussion in the context of the external evaluation of Fund surveillance.

On exchange rate levels and regimes, there had been a recent Board discussion of a staff paper, and the outcome had been that there was not a consensus of the Board on many of the issues, the Deputy Director recalled. Such issues would likely remain under consideration.

On the question of frequency, there appeared to be a wide divergence of views among Directors, the Deputy Director pointed out. The external evaluators had suggested that, in the case of the smaller European countries, resources should be shifted out of surveillance, with much less frequent Article IV consultations, on the grounds that there would be increased interaction with the European institutions. However, the Board had rejected that notion out of hand, so the idea had not been proposed in the staff paper. Nevertheless, there were a number of conflicting and competing factors when considering the appropriate frequency of consultations. However, he would express some concern about the notion that, instead of having a formal mission once a year, the authorities should be contacted by telephone and that surveillance should be conducted in such a manner. A mission involved a lot of work both by the staff and by the authorities, and both sides were well prepared. A formal mission on a regular cycle was a way to focus both sides involved in the discussions.

Mr. Mirakhor said that he agreed with the Deputy Director of the Policy Development and Review Department on the importance of a formal and regular consultation. Every member of the Fund had a right and a responsibility of surveillance on a regular cycle—and the shorter the cycle, the better. In particular, it was important to retain such consultations with smaller countries, as they were the only occasion where the economic environment and the economic policy environments were analyzed carefully. Indeed, the occasion of a Fund staff mission was an opportunity to consider how every element of macroeconomic picture fit together. Some of the smaller countries had been shifted to a 24-month cycle, primarily to save staff resources. However, it was important to recall that surveillance was the Fund's first responsibility, and it was more appropriate to address the resource constraints issue separately. In that context, he would agree with Mr. Taylor's preliminary statement.

Ms. Jul said that she agreed with Mr. Mirakhor. For smaller countries, or even larger countries, that do not have the human capital or institutional setup, the Article IV consultation was often a vital mechanism through which there was coordination of policy. Different public sector agencies, as well as the private sector and research institutes, were brought together to develop more coordinated policy advice. They also provided assistance on data issues and on preparing projections and estimates. Such activities could not be done through remote type of mechanisms. Thus, it was critical that the frequency was not decreased in such cases. Similarly, the idea that consultations could be concluded by the Board on a lapse-of-time basis was inappropriate, as smaller countries viewed the Board discussion and the summing up as an important instrument that could be shared with other policymakers, politicians, and even the market. Therefore, it was also from the point of view of those countries that the idea of saving resources by decreasing the frequency of consultations could be detrimental to their own policy formulation and preparedness to conduct policy.

Ms. Lissakers clarified that, in making her proposal, she had been thinking about the U.S. experience. Clearly, there was no substitute for the face-to-face, formal consultation discussions, which were well conducted and impressive. However, in the context of the U.S. experience, one could wonder about the value-added of the comprehensive consultation every year. Perhaps the staff could conduct a kind of mini-consultation on one or two issues one year, with the full consultation occurring every other year. For example, in the current year, the consultation with the United States could focus on the macroeconomic ramifications of a possible sharp correction in equity markets and the current account deficit. Thus, such a process could be conducted in the case of countries like the United States and the Netherlands; however, the standard consultation process could be continued for smaller countries and others, where appropriate. Nevertheless, somewhat greater judgment and flexibility about the timing of the Article IV consultations, especially with the major industrial countries, might be useful.

Mr. Yoshimura said that he understood the importance of having regular consultations, as well as the importance for many small countries. However, there appeared to be too much standardization and a fixed idea of how consultations should be conducted—for example, with five staff members to cover subjects according a kind of shopping list. It would be useful to introduce flexibility on the timing and the subjects considered, with greater attention being focused on the important issues. Such a process would increase the focus of the surveillance exercise and save resources. In his statement, he had suggested a broader reconsideration of the Article IV process. For example, countries' preference for a 12-month or a longer cycle, as well different possible modalities of conducting the consultation, should be accommodated.

The Acting Chairman cautioned that some Directors appeared to be moving in a direction that he believed should be avoided. The institution had avoided having two classes of members, and it was different from other institutions in that respect. It was important not to damage the basic nature of the Fund. More flexibility should be exercised on the main issues, but many Directors had also expressed concern that certain core issues, such as the exchange rate, had not been sufficiently addressed in every consultation. It would be a mistake to conduct consultations on a less frequent or comprehensive basis for some countries that appeared to be doing well, as that would likely lead to a division within the membership essentially between those countries that would be the object of the Fund's attention and the main shareholders of the institution. That sort of division had been consciously avoided—for good reason.

Clearly, after the main topics had been covered, each staff report should focus on issues that were important to the particular country, the Acting Chairman continued. However, it was important to point out that regular discussions often served to focus careful consideration of the various issues—similar to the reason why central banks had specific, regular meetings to address the appropriate level of interest rates. Therefore, the current Article IV process seemed broadly appropriate. Indeed, one of the criticisms around the time of the Mexican crisis had been that the consultations only occurred once a year; since that time, contact had become more continuous. Nevertheless, the suggestion made by Mr. Yoshimura and Ms. Lissakers that the subjects covered by the staff reports should be more varied beyond the basic areas could be implemented.

Mr. Chelsky said that he broadly shared the views expressed by the Acting Chairman and Mr. Mirakhor. On Mr. Yoshimura's comment on greater selectivity and flexibility, it was important to ensure that a two-tiered structure of membership not develop in the Fund.

Mr. Lehmussaari said that he supported Mr. Mirakhor's comments. It was important that small countries had standard Article IV discussions on a yearly basis. While such consultations were resource-intensive, perhaps other areas could be reduced; for example, it was not always clear why certain topics had been chosen to be included in selected issues papers, as they had not appeared to be directly linked to the policy discussions that had taken place with the authorities. It seemed possible to economize on resources by reducing such work—especially in the case of advanced economies that had many other sources of such analysis.

Mr. Taylor stressed the importance of maintaining an open mind on the subject. Currently, there was a sort of automatic rule that said there should be an Article IV every 12 months—irrespective of circumstances; there was a group of very small countries where an Article IV might occur every two years. However, what a number of Directors had been saying was that the Fund should try to tailor the Article IV process in particular, and the surveillance process more generally, more closely to the circumstances as they occurred in different countries.

In relation to the very small countries, he would agree with Ms. Jul on the importance of assisting in maintaining or developing coherence in macroeconomic policy settings, Mr. Taylor continued. In two of very small countries in his constituency, there had been Fund missions that had been valuable—they had been well led, well conducted, and had repositioned policy in a way that needed to be done in both countries. In both cases, new circumstances had emerged that were leading to substantial policy drift. Unfortunately, that did not appear to be of much concern, as the Fund did not plan on returning before the 24-month cycle ended.

On larger countries, while it was understandable that some Directors were apprehensive about the prospect of ending the annual, comprehensive Article IV consultation with the United States, Mr. Taylor noted that Ms. Lissakers was elaborating the idea that he had included in his preliminary statement. It should be possible to experiment with variations on the Article IV process. In the case of both Australia and New Zealand, the emphasis in the recently concluded Article IV consultation had been on external vulnerability in view of the large apparent external liabilities and large current account deficits. In either country, there did not appear to be any other issue of pressing interest. In such cases, there could have been a targeted consultation either in the capital or in Washington, D.C. The more comprehensive consultation could take place less frequently.

Mr. Esdar said that Ms. Lissakers's proposal was reasonable. The principle of uniformity of treatment did not mean that there should be uniformity in procedures. The issue was not one of large countries, good performing countries, or different classes of countries. Rather, surveillance had to reflect the fact that there were different demands in member countries. For example, in European countries, it was not a matter of size, as statistical systems, for instance, were well developed and there were many independent agencies and research institutes that were involved in the ongoing discussions on issues such as the growth rate and budget deficits. Thus, the fact-finding and data collection elements of the Fund staff in those countries were less critical—especially in the context of the communications advances of recent years. In that context, Mr. Taylor's proposal was interesting; it seemed useful to experiment with more concentrated, shorter consultations with senior decisionmakers on a regular basis, which could be complemented by a standard, comprehensive consultation every two or three years.

Ms. Jul wondered where the line would be drawn in terms of a country and the circumstances. If too much flexibility were permitted, a situation could arise in which there was a sudden change of conditions in a country, and the lack of a regular consultation could allow the country to refuse a surveillance mission, resulting in a deterioration of conditions. While it may be true that it would be discovered that there were few new issues raised in the context of the consultation, that would become clear only after the consultation had occurred. Thus, it was important to retain an annual consultation cycle. On the issue of the selected issues paper, such documents were not only prepared for the Board, but also as a basis for background discussions with the authorities, as many countries did not have the resources to devote to such kinds of research.

Mr. Mirakhor said that, as a representative of developing countries, he supported and appreciated the Acting Chairman's conviction that the Fund should not try to create different classes of members. In that context, he disagreed with Mr. Yoshimura's view that countries could decide on their surveillance cycle. In fact, an annual consultation was an obligation under the Articles of Agreement. Some countries had been shifted to the a two-year cycle in the early 1990s in order to alleviate the workload pressures relating to the membership of the transition. At that time, he had considered the move a mistake; in the event, several chairs had volunteered to move some countries in their constituency to the two-year cycle. It was now time to return to the original policy of the institution on surveillance and cycles.

In order to respond to the point raised by several Directors that surveillance should include the international dimension of domestic policies in the international reserve currency countries, then surveillance of larger countries should be increased, not decreased, Mr. Mirakhor considered. While the focus could change over time, it was imperative that the Fund consider more carefully the impact of larger countries' policies on other countries. In that context, the consultation for countries should remain on an annual cycle.

Mr. Yoshimura said that Mr. Mirakhor was correct with respect to the history of the two-year cycle. Nevertheless, it would be useful to consider whether more countries could be permitted to move to a two-year cycle. That would allow greater flexibility to focus surveillance on the more pressing aspects of the international economic and financial system.

Ms. Lissakers reiterated that it would be inappropriate for the Fund to create two classes of members; if she had believed that her proposal would produce that result, she would abandon it. However, as Mr. Esdar had elaborated, that would not necessarily be a consequence. Clearly, the Article IV consultation was an obligation, and the obligation should be exercised by the Fund at least once a year. However, there could be more selectivity in the formulation of that once a year consultation. For example, there could be a kind of mini consultation one year, and then a maxi consultation for the second year. It would be useful to experiment with such a model.

Mr. Kapteijn remarked that it was interesting to employ Mr. Collins's earlier analogy about the doctor and the patient. It appeared wise to have an annual checkup, because even if patients felt healthy, they have been known to fall suddenly ill. Indeed, the most striking statistic was that two thirds of the Fund's members had had a banking crisis in the past decade. It would appear that Ms. Lissakers's proposal to have a country discuss its minor aches and pains was already prescribed under the current surveillance procedures.

Mrs. Hetrakul said that she supported the Acting Chairman's and Mr. Mirakhor's comments. It was time to return all countries to the annual consultation cycle. It was a concern that there had been one country in her constituency whose annual consultation had been postponed for almost two years. While recognizing the heavy workload of the staff, it was important to have annual consultations on a timely basis.

Mr. Bauche said that simply because there was currently the technical means for more continuous surveillance, or because there were staff constraints, did not mean that the frequency of consultations should be impacted. He was less concerned about having class A or class B countries than the possibility of having class A and class B Article IV consultations. The idea of having alternating mini and maxi consultations could lead to such a result.

Mr. Faini said that he agreed with Mr. Bauche and Ms. Jul that there were many benefits from yearly consultation. He would agree with Mr. Mirakhor that countries should be on an annual cycle—as stated in the Articles of Agreement. At the same time, the fact should not be neglected that annual consultations can strain the resources of the smallest country, and the fact that they had voluntarily moved to the two-yearly cycle was an indication of their preference. How can those different possibilities be balanced? There appeared to be some scope for flexibility. On the matter of a selected issues paper for industrial countries, it would be useful to have such papers focus on the few most critical issues, rather than addressing many different issues.

Messrs. Junguito and Singh said that they agreed with Mrs. Hetrakul and Mr. Mirakhor on maintaining annual consultations, especially for smaller countries.

Mr. Kiekens made the following statement:

I thank the staff for its concise and informative survey of recent experience with surveillance. The comparisons presented in the paper show that Fund surveillance underwent significant positive changes during the last two years. These changes generally accord with the recommendations of the external evaluators. They include more explicit assessment of exchange rate policies, a stronger focus on financial issues and capital account developments, and more attention to economic linkages among countries. Recent financial crises have shown that neglecting any of these areas could significantly reduces the effectiveness of the Fund's surveillance.

Do these changes go far enough? Do they adequately remedy the most important weaknesses of Fund surveillance as revealed by recent financial crises? Let me offer some comments and suggestions.

I believe that Fund surveillance has to evolve constantly. Many issues not explicitly dealt with in the present paper will be discussed in the coming months, including transparency reports, reports on the application of international standards, and the Financial Sector Stability Assessment program. All these discussions will have implications for the future of Fund surveillance, and I think that the follow-up paper on these implications, suggested by the staff to be prepared and discussed prior to the Fall 2000 meetings, would be useful.

Let me now turn to the main issues raised in today's staff paper. First, it is my view that bilateral and multilateral surveillance must remain the backbone of the Fund's activity, for a number of reasons. Surveillance is a major means of averting crisis, and a indispensable source of guidance for countries in designing and implementing sound economic policies. The countries of my own constituency can testify that the Fund surveillance indeed makes useful contributions to policymaking.

I agree that close, and where warranted increased, attention should be paid to the core issues analyzed in the staff paper, as recommended by the external evaluators. I especially urge the Fund to continue its thorough examination of linkages between exchange rate policy and other economic policies, instead of attempting to analyze exchange rate policies in isolation.

The way the Fund exercises firm surveillance over exchange rate policies and balance-of-payments sustainability has changed substantially since the Mexican and especially the Asian crises. It needs to evolve further. For many years, the Fund analyzed a country's position using a financial programming model which focused primarily on financial flows, such as fiscal and current account deficits or savings/investment imbalances, rather than on financial stocks or values-at-risk. The most forceful lesson of the Asian crisis was its demonstration of the inadequacies of this approach. Increasingly, surveillance must use stress testing to determine what value is at risk in case of interest rate or exchange rate volatility. This requires a much deeper analysis of the consolidated balance sheets of all important sectors of an economy: the government's accounts, the central bank's accounts, the banking sector's accounts, and--unavoidably--the accounts of the corporate and household sectors. Such an analysis must include measurement of maturity mismatches and exchange rate exposures. It must determine what means are available and what policies will be useful for reducing or better managing financial vulnerabilities throughout an economy. All this will promote stability and a better risk-growth mix. For these purposes, the upcoming Board discussion on "debt- and reserve-related indicators of external vulnerability" and "Macroprudential indicators" are important for achieving what Ms. Lissakers rightly considers essential: "to promote a more fully integrated assessment of countries' liquidity and balance sheets."

Today the staff is seeking the Board's guidance on the distinction between core and non-core issues. This is a difficult question, because the line between core and non-core issues may have to be drawn differently from one country to another, or shift its location in a single country over time, as a result of changes in the world economy or in individual economies. But difficult as it may be, and subject to change, such lines must be drawn. Systematic coverage of non-core issues in all reports is not feasible, but we cannot afford to neglect such issues completely. We must strike a reasonable balance between these extremes.

Our current practice of selecting what non-core issues should be dealt with on the basis of their macroeconomic relevance is conceptually valid, but may be operationally hard to implement. One reason is that it may be difficult or impossible to tell in advance what non-core issues will prove macroeconomically relevant. Sometimes such relevance is only evident in retrospect, and sometimes can only be demonstrated by a detailed study of the issues. The problem is well illustrated by the recent financial crises, which originated in areas that were not then considered part of the Fund's core business. We need to think about this problem more thoroughly with a view to giving the staff additional guidance on criteria for the objects of their scrutiny. For example, we could establish a system for classifying non-core issues, ranging from structural issues close to the Fund's concerns (e.g., labor markets, social security and its fiscal implications) to issues that are more remote (e.g., military spending or environmental concerns). In addition, wherever possible, the staff should use information from other institutions that analyze developments in areas not normally among the Fund's core concerns. This could help the staff make judgments about their possible relevance to macroeconomic development.

I would also add that including non-core areas in Fund surveillance does not necessarily mean that the Fund should seek solutions to problems it identifies. We cannot be doctors who treat every illness we identify in the course of our surveillance. Other institutions and forums possess a wealth of expertise, which the Fund should not hesitate to use in its surveillance activities.

A major reason for supporting a more selective distinction between core and non-core issues in Fund surveillance is to ensure that the Fund's increasingly complex surveillance agenda does not outstrip the limited amount of staff resources available for carrying it out. At the same time, it would be unacceptable for Fund surveillance to treat large, medium-sized, and small countries differently. We may distinguish between core and non-core issues, but we must not distinguish between core and non-core countries.

Let me say a few words on multilateral surveillance. I think that recent years have seen much improvement of both the quantity and quality of multilateral surveillance, and the staff of the Research Department and other departments that contribute to multilateral surveillance deserve our appreciation. Multilateral surveillance often shows issues in a different light from bilateral surveillance, which gives it a very important role in Fund surveillance generally. External evaluators mentioned the need to improve the cooperation between Fund's area departments and functional departments, and during the Board's discussion of their report, I voiced my expectation that we would soon see much closer cooperation between the International Capital Markets division and the Article IV consultation teams. Today I welcome information in the staff report about the cooperative efforts of the Research Department and the area departments in evaluating countries external vulnerabilities. Nonetheless, I wonder to what extent this good example reflects a general improvement in communication and cooperation between all the Fund's area departments and functional departments.

To change the subject, the staff report notes in several places that certain tasks, such as the assessment of financial sector vulnerability, external vulnerability, or the appropriateness of the exchange rate level, has been hampered by a lack of data or analytical tools. However, the reasons for omitting these assessments were not always made clear in staff reports. I would have expected that staff reports would always include such matters as the assessment of external vulnerability and appropriateness of exchange rates. I would also expect that in cases where lack of data or other failures make a thorough assessment difficult, the reasons for the omission would be clearly stated, together with the authorities' plans for improving the situation.

Finally, I was interested to note how the treatment of capital account liberalization has changed. Since mid-1998, this issue has been mentioned in only 29 percent of country surveillance reports. The staff attributes its reluctance to take a firm position partly to the unsettled views of professional economists concerning the costs and benefits of capital account liberalization. Since in some sense this issue will never be settled, there seems to me little point in waiting for a strong consensus to develop before taking a more outspoken position on capital account liberalization. It also seems to me that there is now a consensus about what conditions can ensure that the benefits of capital account liberalization exceed its costs, and I think this consensus gives the staff a reasonably firm basis for speaking out more strongly on capital account liberalization.

Mr. Collins said that he agreed with virtually everything Mr. Kiekens had said, but he would particularly underline the importance of overall balance sheet analysis for an economy, including the public and private sectors taken together. The Financial Stability Forum working group on capital flows, the reports of which would be seen before the spring meetings, would help the Fund further along in that direction.

Mr. Bauche made the following statement:

We seem to have a lot of medical analogies today. In many ways, it seems to me Fund surveillance is similar to asking the patient to go regularly to the dentist, rather than waiting until the toothache becomes unbearable. And conversely, such prevention efforts can only be well-perceived by the patients if they are sure that the dentist keeps his own knowledge up to date. Here, let me thank the staff for the remarkable study of the IMF dental clinic track record over the past two years.

I will insist on three avenues suggested by staff: Financial sector surveillance, regional surveillance, and selected coverage of noncore issues.

On the financial sector surveillance, many areas of progress are very well identified by the staff and I encourage them to incorporate into surveillance a range of indicators covering capital account vulnerabilities, the domestic financial system, including the nonbanking sector, as well as the coverage of developments on financial markets and indicators of market perceptions.

On the reinforcement of regional surveillance beyond terminology, it is probably a missing link between, on the one hand, the country surveillance; and on the other hand, the WEO analysis or the international capital market reports. Staff efforts to incorporate cross-country themes into bilateral surveillance are well under way, and this welcome development could very well delve even more into the general consistency between exchange rate regimes for neighboring countries. Let me also say that I support Mr. Kiekens in the fact that the Fund should continue to examine exchange rates in relation with economic policies.

I also think that regional surveillance can be improved by developing more informal Board sessions on regional matters.

Another avenue which is worth exploring concerns improvements in practices of Fund surveillance in selected regions. Here, I refer to the very useful Table 4, page 39 of the background paper, which describes the current practices related to the surveillance of the euro area, the WAEMU, CAEMC, and others, considering the very interesting and periodic reports repeatedly discussed in the Board, notably the one about CAEMC, I would suggest gradually formalizing gradually the practice of regional surveillance relating to the CAEMC or the WAEMU reports. For instance, the next Board discussions about regional developments in CAEMC or WAEMU could give rise to a summing up rather than concluding remarks. Such a formalization could help in deepening the consultation process between staff and the authorities in the conduct of the regional surveillance exercise.

On the coverage of noncore issues, I welcome staff's others to overcome a somewhat unhelpful controversy on the precise limitation between core and noncore issues. But, in fact, to the extent that those non so-called noncore issues are fully part of the economic picture, when they are of relevance to the macroeconomic situation, I wonder whether this noncore area is not misleading us by giving the impression that the Fund could avoid dealing with such issues. It is probably just a matter of semantics, but like Mr. Bernes, I would say that it would probably help us to start reasoning in terms of core and noncore issues. Like Mr. Collins and Mr. Kiekens, I guess we could use more medical analogies. One that could come to mind is about cardiologist. Would the patient really feel safe if his heart specialist insisted on dealing only with his own core issue, the heart, to the exclusion of other imbalances in the human body that could very well impact his own diagnostic area, and that on the grounds that he is not responsible, but other specialists are there to find out these problems.

So, in that sense, I can only but support the flexible coverage of issues such as those described in paragraph 64, labor market issues, social security, health care reforms, poverty, environment, military expenditure, when they impact significantly the economic situation. I would also point particular emphasis on governance issues in which I would include the fight against corruption and money laundering.

I have one concern about exchange rate matters. I thank staff for their frankness toward the Board when they indicate that, I quote, "silence in some staff reports either on the level, regime, or staff authorities' views, may have been wholly appropriate." But for who is it appropriate? Certainly not for the Board, prevented from the possibility of exercising firm surveillance over the exchange rate policies of Fund members. Therefore, the Executive Board, "responsible for conducting the business of the Fund," according to the Articles of Agreement must be kept fully current on the state of discussions between authorities and staff. This could be done, indeed, through the Article IV reports. But here, we are fully aware of the existing discomfort of the authorities with staff reporting to the Board on such market-sensitive information. And, as staff suggests, this discomfort would certainly be increased by a possible publication of Article IV reports. Here, I cannot help but think that the road to hell is paved with good intentions.

So we are left with probably two choices. One is the concept of vulnerability supplement proposed by Mr. Wijnholds. There is possibly a second option. I understand from staff report, footnote 23, page 22 that in some cases, informal country matter sessions are used to communicate to the Board, the staff analysis on exchange rate issues that have been discussed with the authorities. Indeed, I would prefer to deal with those matters in the context of Article IV. But, if that possibility is not practicable, the existing practice of consultations established so far for some countries, should be generalized. I would accept it as a second-best, considering the legitimate need to inform the Board on an undeniable core issue.

One last word, since we are today on medical analogies. Mr. Wijnholds has compared the Fund to a "shrink" or psychiatrist. That is a very good metaphor. I would not push it too far, since it is usually said that you go to a shrink when you are slightly cracked, but you keep going until you are completely broke.

Mr. Esdar made the following statement:

I do not want to talk about medicine, but at this stage of the discussion, I feel a little bit like a doctor who came to the conclusion that surgery was successful, but the patient is dead, actually, and it was a little bit my impression from this discussion. When I prepared by statement yesterday, I had a clear feeling, but after this discussion here, I am not sure I target the right points. I think in my view, one point is pretty clear coming out of this discussion, that this discussion today can be only a preliminary one, and preliminary for two reasons, the first reason, and we discussed it under the heading of core of the Fund and other questions, we need a general discussion on the role of the Fund, I think. We need it urgently, that is reflected by the discussion quite clearly. We targeted today the issue what we should do under the heading of surveillance, but I think that there is a broader issue, we have to discuss and we have to become clear whether this institution is going in the direction of becoming a more focused on the question of preventing crisis and dealing with crisis, or whether this issue has also an important role in helping countries to overcome longer term balance of payments problems in a preventive way, I think. This all has implications for the surveillance process, that has implications for the way we deal with these countries. But, we cannot discuss surveillance without having a clear function what the financial role of this institution is. Therefore, I think it is crucial to come back to this issue on more general terms, and therefore my remarks later on, on the core and noncore issues will always be made with the caveat of having this general discussion.

The second point why this discussion can only be preliminary is that, in particular in crucial areas that will affect surveillance in the future—such as standards, the Financial Sector Assessment Program, transparency, the question of indebtedness indicators, and external vulnerability—we are still as a very early stage in our discussion, reflected the by pilot projects and upcoming reviews. We have to integrate these new elements based on the experience which we will gain in the near future into our surveillance procedures and guidelines. This background I fully endorse, the proposal or assumption of paragraph 16 of the paper to discuss a general revisions of our surveillance guidelines at a later stage, probably around the annual meeting, hopefully before the annual meetings. But only after we have solved the more general issues I mentioned before.

The very interesting and comprehensive staff papers demonstrate that the focus of the Fund's surveillance is a consequence not only of the Asian crisis, has changed significantly over the past years. Exchange rate questions, the stability of financial markets, governance, transparency, and data dissemination issues have increasingly moved toward the center of the surveillance process. Insofar, I was somewhat astonished to read this as one of the central recommendations by Mr. Meltzer and his colleagues, who not only here seem to be somewhat behind reality and schedule. This does not mean that we should be satisfied with the progress in this area so far. As already mentioned, in many areas, we are still very much at an early stage. We have to continue our work on standards and external debt sustainability, on financial sector sustainability, and reserve management strategy. Standards have to be further improved and integrated adequately into the surveillance process. There are still questions with regard to the division of labor and responsibility among the relevant institutions.

This brings me to the difficult question of what constitutes the Fund's core responsibilities. We can certainly all agree that exchange rate, fiscal, and monetary sector questions are crucial elements of the Fund advice and have to be. In this regard, I was very much encouraged as evidenced by the background paper that in particular exchange rate issues have gained more prominence in Article IV discussions over the last years. However, the statistical facts provided in Table I are somewhat misleading. To put the exchange rate policy at the core of the surveillance process would mean to have an active discussion with the authorities about the appropriateness of the exchange rate regime and in the case of fixed or pegged exchange rates, the exchange rate levels, and to discuss the potential consequences of certain exchange rate regimes in light of the overall macroeconomic framework on financial sector stability, external indebtedness, and competitiveness. This goes beyond reporting on real exchange rate developments, discussing competitiveness indicators, or discussing equilibrium exchange rate and exchange rate models. We have to have an active policy discussion in this area.

I am aware that here there is a problem between transparency on the one hand and confidentiality on the other, but these elements are crucial for the surveillance process. They have to be submitted to the Board and not to talk to this issue because of confidentiality considerations, cannot be a solution. I think wife to find ways and means to deal with that. The proposal to take it up on informal country sessions, in my view, is not sufficient. We have to do it in the context of the surveillance process and to find appropriate vehicles to inform the Board about the thinking of the authorities and the staff in this regard. Maybe we have to think in the direction of having a separate section in the Article IV report, which is not published later. But we have to find a way to deal with it.

As earlier mentioned, there is certainly no doubt that macroeconomics have to be in the center of the Fund's surveillance. It is much more difficult to come to the right judgment with regard to structural policies. Experience over the last year have clearly demonstrated that macroeconomic performance and outcome have quite frequently been driven by structural rigidities and shortcomings. An effective surveillance has to reveal the rules of shortcomings and imbalances, irrespective whether these rules are macroeconomic or structural ones. A difficult question, however, would be who should advise member countries in tackling structural problems. Here, my response and advice would be to limit the Fund roles as much as possible, and to refer countries directly to other specialized institutions or to use their knowledge and competence as an input for our own Fund policy advice. But, this is, these issues have all to be also in the broader context of the role of the Fund.

To decide on the focus of the surveillance process in light of the country's particular circumstances at the same time would bring about more selectivity and better focus of the surveillance process. There is no need to routinely cover the entire potential surveillance agenda, in particular when it comes to structural issues like poverty reduction, social safety net, military expenditures, trade, and so on. This brings me to the more procedural issues which in my view often, and also today in my view, are too narrowly discussed under the heading of 12 rather than 24-month cycle or under the heading bilateral versus multilateral surveillance.

In my view, surveillance should be an ongoing process. Modern information and communications technology provides the opportunity for continued exchange of information. So far, Article IV missions should relieve from this task. Discussion on industrial countries which do not need technical support in these areas, but also in program countries in our World Economic and Market Developments and WEO sessions is already based on the continued flow of information using different communication channels. To strengthen this process would provide the opportunity for the annual mission, I repeat, for the annual mission, to concentrate on crucial policy questions which could be discussed at the appropriate high political level.

I could also imagine that full-fledged consultation reports would be provided to the Board only two or three years as a kind of stock taking exercise, while concentrating in between Board information and Board discussions on those areas which are identified as being the crucial and vulnerable ones.

Mr. Wei made the following statement:

I welcome today's discussion and would also like to take this opportunity to express my appreciation to the staff for providing this well-written paper which comprehensively covers the Fund's surveillance experiences during the past two years. It is beyond all doubt that much progress has been made since the last biennial surveillance review. I agree that Fund surveillance of core areas has been strengthened, especially since the Asian financial crisis. I agree with other speakers that exchange rate regimes and policies, monetary and fiscal policy, balance of payments, the financial sector, and related structural issues are central to the Fund's mandate.

The Fund should continue to play a central role in crisis prevention and management. For non-core topics, while I admit that they should be addressed only if relevant to the macroeconomic situation, I would rather go along with the view that they should not dilute the importance of the core issues. Among the so called non-core areas identified by the staff in the paper, in my view, since the poverty reduction issue in many aspects is directly or indirectly linked to the macroeconomic development of the poor developing countries, I have no objection to the Fund having greater cooperation and a clearer division of labor in this field with regard to other relevant international financial institutions, especially the World Bank. However, that does not mean that we should totally ignore this important issue, particularly, helping the PRGF countries improve their macroeconomic management skills, designing policy frameworks, and providing concessional financial assistance to support the implementation of these policies. In the meantime, the Fund should not touch upon political issues, which may conflict with its own Articles of Agreement. In this context, I agree with Mr. Shaalan and Mrs. Farid's view expressed in their Gray that, as a matter of principle, the Fund should not acquiesce to pressures from outside fora in venturing into some non-core areas.

This being said, I would like to turn to some specific issues.

First, on surveillance over exchange rate policies. Generally speaking, I agree that Fund surveillance in this area has been strengthened and appropriately focused. Since exchange rate changes among the major currencies have a great impact on international capital markets, the Fund should further strengthen surveillance of these changes. As a result of Fund research, we have come to the conclusion that there is no single exchange rate regime which could be applied to all countries. Each country or economy should decide which exchange rate system is appropriate according to its own macroeconomic situation. In my opinion, this important finding should be further stressed in the staff paper.

Second, on strengthening surveillance for emerging-market countries. While I agree that Fund should provide the necessary technical assistance to emerging market countries to improve their reserve and debt management, I am of the view that dissemination of reserve data, should be conducted according to the voluntary principle. I believe that improved transparency for all market participants is conducive to crisis prevention. This process should be symmetric, not only including the emerging market authorities, but also private sector activities, especially the highly leveraged institutions(HLIs). Otherwise, it may not be appropriate, and at the extreme, may expose the emerging market to a more risky situation. Due to the large capital stocks and the strong spillover effect, the mature economies have a far greater impact on the international capital market. Therefore, it is of vital importance that the Fund should strengthen its surveillance of the matured economies, especially those of the major industrial countries.

Third, on developing and disseminating knowledge of cross-country and regional issues. The Asian financial crisis has increased the attention paid by the Fund in studying the spillover effects of the systemically important economies, and I think efforts in this field should continue to be made, especially in those major currency countries. With regard to participation in regional fora, I can endorse undertaking the current experiment, however, given that the staff is already overstretched, necessary budgetary support in term of adequate staff resources should be considered. However, I share Mrs. Hetrakul's view that "we specifically disapprove of the reference to any national forum and its demands. It is not possible for staff to keep track of all such 'fora' and uphold the principle of uniform treatment in this respect."

Fourth, on multilateral surveillance. I see great merit in multilateral surveillance as carried out in the WEO, ICM reports, and the WEMD sessions. Within the past two years, the staff has developed some new methodologies to analyze macroeconomic development and I encourage the staff to continue these efforts. However, as staff correctly points out, these new methods, such as Early Warning System Model, are still far from perfect.

Therefore, like Mr. Shaalan and some other colleagues, I would caution against a more extensive use of EWS or vulnerability indicators. In this regard, we notice that staff expressed their views on China in Box 16 on page 54 to which we did not agree as we made very clear on the occasion of the Board's discussion on China's Article IV report.

Fifth, on some ongoing pilot projects aimed at strengthening Fund surveillance. Although I know that it would be appropriate to make some assessments at the time to review these initiatives, since staff mentioned them in the paper, I would rather make a few comments in advance. For the release of Article IV staff reports, I share some of the staff's concerns and do worry about the potential erosion of the candid atmosphere between the authorities and the staff. For the Report on Observance of Standards and Codes, I think this kind of report should be used as a reference guide, and not as a mandatory instrument which member countries are forced to abide by.

On the issue of the Article IV consultation cycle, I associate myself with Mr. Mirakhor and others in that the principle of uniformity should be strictly observed. Therefore all countries should have consultations on an annual basis.

Finally, I agree that in order to keep a proper balance between an increasingly complex surveillance agenda, frequent consultations, and effective surveillance in the period ahead, we should consider increasing our resources, on the understanding that the current resources be further optimized.

Mr. Barro Chambrier made the following statement:

We would like to thank the staff for this very useful set of papers which highlight progress achieved since our last review. Let me state that overall there is a broad agreement that we have made headway on the surveillance process, but that it can be improved in several areas, drawing mainly from the recent experience. In this regard, a number of specific recommendations were made by the evaluators, with a view to strengthening the surveillance exercise, and making it more responsive to changing global conditions, both at the country level, as well as at the regional level. We think that the debate on the scope of Fund surveillance and its limitations to core issues or venture into noncore issues need more exploring.

On the scope of Fund surveillance, and core versus noncore issues, we need to recognize further that the surveillance exercise has evolved over the years and the Fund has gained much experience in dealing with important areas such as the exchange rate, the financial sector, the capital accounts, and cross-country themes. Obviously, the complexity of the globalized world and increased integration of economies has called for an extension of Fund surveillance efforts toward crisis prevention. In the same vein, as a matter of equity, one should regard Fund interest in other domain such as social issues and issues related to poverty as essential. In fact, the Fund should adapt its surveillance policy to reflect the particular situation of countries and exercise a case-by-case approach and target an efficient process with available resources through better prioritization.

On the scope of surveillance, we have a concern related to the debate on the core noncore issues. The focus on the core issues of exchange rate policy and directly associated macroeconomic policies seems to us somewhat limiting. By focusing only on a few areas, we may not only miss important developments that could have a systemic impact, but we would also ignore the difference in the nature of the economies of the membership. Core issues differ not only across countries, but also across time, as noted by Ms. Lissakers, even for particular countries. For instance, as rightly pointed out by Mr. Collins, PRSB presents a new agenda and without consideration of monitoring arrangements, the process risks weakening. Thus, while we recognize that in some areas it might be more efficient to rely on outside expertise or other more specialized agencies for advice, we still think that for certain recurring issues, namely as regards the financial and social sectors, we should continue to respond adequately to member countries' demands. To close on this issue, we could not agree more with Mr. Bernes and Mr. Chelsky that issues that could be called to Fund surveillance are those that have the greatest relevance to a member's macroeconomic situation, and policy prospects.

On bilateral versus multilateral surveillance, while we believe that bilateral surveillance exercise is important for individual countries, the increasing economic and financial globalization call for more attention to be devoted to regional surveillance. Annual bilateral surveillance provide a number of critical advantages that could be lost with less frequent consultations. Notably, when it comes to sensitive issues like the exchange rate, bilateral discussions could better serve candor and frankness. In this area, we would like to reiterate the recognition by this Board that no single exchange rate regime is appropriate for all countries, and that the final choice of a regime lies with the country. Thus, bilateral surveillance is too important an exercise for the smaller economies which consider Article IV missions an important form of technical assistance, where macroeconomic and other relevant issues can be analyzed and discussed openly. Bilateral discussions with the country authorities can be also useful when it comes to cross country reference by drawing from the experiences of other countries facing similar policy problems.

It is one aspect where the Fund has a comparative advantage, and can greatly benefit the membership. Thus, we would like to emphasize the need to maintain the frequency of Article IV consultations and the focus on individual countries by allocating more resources to this exercise. We thus agree with

Mr. Taylor and Mr. Woolford that the Fund's smallest member should be encouraged, not discouraged, to have frequent policy contact with the Fund.

On regional surveillance, we believe that progress has been achieved, but that some improvement can be brought to the process. As is the case with African countries of the WAEMU and CAEMC regions, regional surveillance can be improved by having a separate and special Board discussions on issues which are considered to be of regional importance, and by issuing summing up of discussions to complement bilaterals country consultations, rather than concluding remarks alone, as noted by Mr. Bauche.

Finally, like Mr. Shaalan and Mrs. Farid, we concur that views expressed in a report like the WEO and the IMFC should filter more to area departments, and that a better coordination among departments involved in multilateral surveillance should be strengthened to allow for a better evaluation of risks.

In conclusion, Fund surveillance should not only be regarded as of high quality, but as evolved over time, showing the degree of flexibility and adaptability of the institution. Although there are areas where improvement is warranted, the overall process has served the institution to deliver on its mandate, while taking into account the particular difference in interest of its member countries. Thus, we should have an open mind when dealing with issues of interest to our member countries, and not limit the expertise and mandate of the Fund to some traditional core issues, thus ignoring the problems that matter most for some of our countries, particularly the poorer ones. The Fund mission is to remain vigilant to respond to member country needs and concerns, and to be ready to provide them with the best policy advice possible

The Executive Board recessed at 1:00 p.m., and reconvened at 2:30 p.m.

Mr. Lushin made the following statement:

Let me begin by thanking the staff for their great effort in compiling the report, which is before us today. It reflects clearly big challenges that the rapidly changing world economy puts before the staff and also demonstrates their forceful efforts to face these challenges. This is inevitably an interim assessment since many initiatives and programs that will eventually influence the Fund's surveillance are now under consideration. But even as such, the report shows that so far the staff have been responding adequately to the Board's reaction to the report of External Evaluators. Let me now turn to the issues suggested for discussion.

The question of core versus non-core areas of the Fund's activities is a subject of a rather long discussion. I think that in order to arrive at a reasonable agreement on this matter, a pragmatic approach should be adopted.

What we define as core areas for the Fund should be directly and prominently related to the macroeconomic health of its members. The concept of core issues is continuously evolving and now it covers the financial sector, the capital account and cross-country themes. These core areas as currently defined should form a basis for surveillance for all member countries. The areas currently defined as non-core consist of a number of topics stretching from labor markets to governance and include the whole variety of structural reforms. The macroeconomic relevance of these issues is country and time specific. Therefore, leaving the coverage of these areas for a particular country to the staff's judgement is the only practical solution. In other words, I believe that the current selective practice of the coverage of non-core issues in bilateral surveillance as exercised by the staff is appropriate. Of course, this selectivity should be based on significant and direct macroeconomic relevance, as pointed out by Mr. Yoshimura. There may also be some merit in a mandatory litmus test for inclusion of non-core issues as suggested by Mr. Wijnholds, even though it is difficult to imagine that the staff are willingly making their lives more complicated by considering an issue which is irrelevant or can be covered by another IFI.

While reading the staff report I got an impression that one of the reasons why the staff raise the issue of core/non-core areas is that they are seeking Board's guidance on, or even protection from, external pressures for systematic coverage of some non-core issues in bilateral surveillance. This is quite a legitimate request and I agree completely with Mr. Shaalan and Mr. Kelkar that such pressures should be either resisted or responded by the collective discretion of the Board.

Exchange Rate Policies. It is my view that following the Asian and Russian crises surveillance over exchange rates has been strengthened and became better focused. Analytical tools being used in bilateral exchange rate surveillance have been advanced, including through using the CGER methodology for most industrial countries and some emerging market economies. The considerable progress has been achieved in multilateral and cross-country surveillance of the exchange rates and a number of high quality papers on these issues has been presented to the Board. This said, I think that much more can be done to further strengthen surveillance over exchange rates, especially for transition and emerging market countries. In this context, I welcome staff's intention to extend the CGER framework beyond industrial countries even despite methodological and data problems that can emerge in this case. I see merit in Ms. Lissakers' and Mr. Sobel's remark that reliance on CPI-based real exchange rates may not always be appropriate to assess exchange rate levels, particularly in emerging markets and transition economies. Finally, like Mr. Portugal, I think that greater attention can be paid to the analysis of the exchange ratios between the dollar, Euro and yen and the international implications of their movements.

A big issue relating to the exchange rate surveillance is a trade-off between the candor of staff assessments and policy advice and a presumption in favor of publication of staff reports. For the same reason only about a quarter of staff reports include authorities' responses to staff recommendations on the exchange rate policies, which is also a serious disadvantage. This issue should be promptly addressed in order for the Board to be fully informed of the existing situation. I will elaborate on this issue below when speaking about vulnerability assessments.

I welcome increased emphasis on cross-country themes and multilateral surveillance. Analyses relating to spillover effects and cross-country comparisons appear in the increasing number of Article IV Consultation reports, and this undoubtedly increases their quality and usefulness. WEO and ICM reports are of top quality and their focus reflects adequately the most recent developments in the world economy.

I admit that multilateral surveillance provide valuable inputs for bilateral surveillance exercises. However, I believe that there is still some way to go in establishing a stronger coordination between these two areas. There is also another type of coordination that may need to be improved – coordination between multilateral surveillance and individual country's programs.

I noticed, for example, that in many UFR cases baseline balance of payments projections include forecasts for exports and private capital inflows that are overly optimistic compared to historical trends. I wonder if these projections are subject to any form of multilateral clearance, say, by adding up export and capital inflow forecasts across countries and assessing the totals against WEO and ICM data.

Concerning assessments of vulnerability, I agree with Mr. Wijnholds that heightened attention to vulnerabilities could be the single most important improvement in the Fund's surveillance. It is, therefore, appropriate to include, in line with his suggestion, a vulnerabilities table in every country report. Of course, the work on the vulnerability indicators is still ongoing, but some conventional ones are already available for a large number of countries and their usage should be encouraged. Reserve and debt related indicators are especially important and I look forward to the Board seminar to discuss their operational usability.

While there is no disagreement that vulnerability analysis is a necessary exercise in the context of bilateral surveillance, the main controversy surrounds the way to present its results. Here I agree with the view expressed by external evaluators and forcefully supported by a number of Directors that confidentiality of vulnerability analysis should be preserved in order to provide the staff with a channel through which they can communicate confidential and market sensitive information. This may be done along the lines suggested by Mr. Wijnholds by adding a vulnerability supplement to the Article IV Consultation report. Moreover, this supplement could include some other information that the authorities would not like to disclose, for example, on the exchange rate level or regime.

Finally, on the resource implications of the increasingly complex surveillance agenda. It may turn out that the increase of staff committed to surveillance will not be sufficient to cover all the existing needs. Therefore, the solution lies in the optimization of the use of resources that are already available, including through less extensive and more flexible consultations with countries where the possibility of a serious crisis is out of question. Also, extreme selectivity will need to be exercised in the coverage of non-core issues.

Ms. Jul made the following statement:

Significant progress has been achieved over the past three years regarding surveillance reflecting the lessons learned from the Asian crisis. This progress notwithstanding, many issues remain and I will discuss some of them.

I agree with other Directors that while there are core areas such as the exchange rate, monetary, fiscal, financial sector, capital account and cross-country issues that should be included in all bilateral surveillance reports, there may be non-core areas that are country specific, that may evolve through time, and which are key in assessing macroeconomic performance and prospects. However, in determining the non-core areas on which to conduct an in-depth analysis, it will be necessary to consider that if they lie outside the realm of staff expertise there is a risk of a superficial treatment of the issue, that could affect the credibility of the overall policy advice. Of course, staff can utilize expertise from other institutions but it may be at the expense of important shortcomings in producing timely analysis of consistent quality due to coordination problems. In this regard, I share Mr. Shaalan's views that there would be efficiency gains to be made in housing expertise on financial sector matters within the Fund. On this same topic, it has been my experience that there is a list of non-core issues that staff was expected to include in the reports whether or not they were considered to have a substantial effect on macroprospects, so I welcome Directors' request to justify the inclusion of non-core issues from a macro point of view and not just have a check list.

On the exchange rate, although I agree with staff that there has been significant progress in this area, it is surprising that this issue is still not covered in all reports. Moreover, there appears to be substantial shortcomings regarding the quality of the treatment of exchange rate issues. Staff's views should be pared with the authorities' views, the reasons for differences in views discussed, and an analysis of changes, if any, in the authorities' position from the previous report included, pointing out if the changes resulted from staff's advice and/or reflected new developments.

In view of the conflicting evidence as to the effectiveness of capital controls, particularly in the short-run or in the event of speculative attacks, I welcome, like other Directors, the change in staff's views regarding the advisability of a swift liberalization of the capital account to a more balanced approach of analyzing the costs and benefits of eliminating controls. As a result, a more cautious approach to ensure that the necessary pre-conditions are established and that an appropriate sequencing is defined now being recommended.

Appropriate vulnerability indicators are key to an effective surveillance process. However, availability and quality of existing data make it difficult to construct such indicators. Efforts by the staff need to continue and a coordinated approach by departments in this area is important to ensure comparability across countries. Alternative scenarios are another instrument to provide insight on potential risks and highlight vulnerabilities.

Confidentiality is also key to conducting an effective surveillance. It is necessary that the authorities are prepared to share their views with candor with staff and the Board. In this regard, although I recognize the need for transparency and the advantages of conveying information to the market, an important trade-off may arise regarding candor and transparency if the publication of staff reports is made obligatory. Although the use of a "vulnerability supplement" as suggested by Mr. Wijnholds could help in this regard, many countries could still see the publication of the reports as a problem.

In line with other Directors, I was not convinced by the analysis presented by staff on output gaps. More questions than answers were raised in my mind and I think that further study is necessary. Also, the bias regarding staff advice needs to be analyzed for countries other than the industrial ones.

On cross-country issues, I agree with other Directors that it is an area where the Fund has a key comparative advantage and that this expertise should be incorporated more comprehensively in the bilateral surveillance. I have found that authorities value recommendations that are put to them in the context of other countries' response to similar issues and that often they seek this kind of analysis from staff, particularly in relation to countries with which they share common characteristics. Other countries' experiences also gives authorities insights on the potential risks that they face from events occurring in the rest of the world.

Efforts have already taken place to reduce the amount of resources used in bilateral surveillance by economizing on Article IV staff resources.

The proposals raised by some Directors to further this effort by revisiting the issue of frequency of Article IV consultations, streamlining missions, more continued surveillance with remote fact finding, and more consideration of surveillance papers on a lapse-of-time basis may be more appropriate for industrial countries when judged from the point of view of the needs of the country, albeit not necessarily from the point of view of the cost of bilateral surveillance. I say this because regarding many member countries, Article IV missions are an important mechanism to provide assistance to the authorities on coordinating policy formulation within the public sector, preparing projections and estimations on key sectors of the economy, sharing views with technical staff on different issues, all of which they are hampered to do themselves because of data problems, the institutional setup, and human capital availability. Moreover, some countries view the discussion of the consultation by the Board and the ensuing summing-up as a valuable instrument to share with policy makers and politicians in the country as well as with the market, and this is the reason why they object to consideration by the Board of staff reports on a lapse-of-time basis.

In sum, significant progress has been accomplished in strengthening the surveillance process over the past three years. However, more remains to be done particularly in regards to defining an appropriate strategy to provide guidance to staff on selection of non-core issues; ensuring that discussions and report of discussions to the Board are frank and incorporate fully the authorities' views on exchange rate and financial sector matters; striking an appropriate balance between transparency and confidentiality issues; balancing the needs of countries served by the surveillance exercise with the budgetary constraint imposed by the availability of Fund resources devoted to surveillance; and developing vulnerability indicators that are comparable across countries against the backdrop of substantial data deficiencies in many countries and yet inadequate Early Warning Indicators.

Mr. Mafararikwa made the following statement:

Like other Directors, I thank the staff for this in-depth stock taking of the state of Fund surveillance. The staff have gone to a great length in showing how current and past practice in staff work could relate to core and noncore Fund activities particularly on country matters. This is a very useful exercise, particularly with the current pressure to forecast the activities of this institution toward core issues. And indeed, the recent Board retreat, at the recent Board retreat there was consensus on the need to refocus the activities of the Fund to make it more effective in a dramatically changed global environment. In the debate between core and noncore areas, I side with those who uphold the principle that what should matter for Fund surveillance is what matters for the maintenance of macroeconomic stability. There is need for flexibility as to what constitutes core issues when dealing with particularly with PRGF cases. While issues like structural reforms, infant mortality rates, illiteracy rates, unemployment, governance, and other issues such as second generation reforms may not be regarded as core Fund issues, Fund involvement in these countries cannot be meaningful without attention to these issues which are core for macroeconomic and social stability, growth and the reduction of poverty in these countries. In this regard, consideration should be given on how PRGF is integrated in the surveillance exercise.

The rapidly changing global environment and the problems affecting many developing countries have shown that what matters for the macro economy has not remained static over time, and is not standard for all countries. In particular, the recent crisis have amply demonstrated the need to pay close attention to vulnerabilities which may be key to strengthening the Fund's role in crisis prevention. In this connection, it is justifiable for the Fund to conduct in-depth analysis of exchange rate regimes and developments, banking sector soundness, and trends in capital movements which should rank high on the hierarchy of concerns for the Fund.

Based on the nature of the recent financial crises, I find appropriate the Fund's interest in analyzing the composition, nature, and speed of capital mobility. In this context, we welcome the change of heart toward the pace of capital account liberalization, acknowledging that while there is general consensus on the requisite, prerequisites for capital account liberalization, the discussion on the benefits and/or costs of faster pace of opening up remains inconclusive.

Regarding multilateral surveillance, the staff notes that cross-country issues related to spillover effects and their pertinence to multilateral institutions should be one of the Fund's strongest areas of influence. This seems appropriate in a potential after for the Fund to address regional issues, in areas other than currency unions in a motor forthright manner. As it relates to Africa, we see scope for more effort in this area, given the progress made toward liberalization of trade in the growing regional linkages, there is need for more intensive discussion in Article IV consultations of the impact of policy developments in neighboring economies, including exchange rate developments and financial crisis contagion. In addition, appropriate policy responses, including under Fund programs, should bear in mind regional vulnerabilities and cross-country effects.

Regarding resources, we agree with Mr. Bernes that we should not necessarily regard as noncore those issues that we currently lack expertise in. Besides, there is need for very close liaison with other institutions on many matters. In the particular case of PRGF cases, the expertise gap can be narrowed by overlapping Fund and Bank missions, as well as making extensive use of bank reports on poverty and other issues which fall under their auspices.

Finally, on the frequency of missions, I support the view of returning to the annual cycle as prescribed in the Articles of Agreement. I also support Mr. Taylor on the call for a more frequent policy conduct between the smallest members in the.

The Deputy Director of the Policy Development and Review Department remarked that it would be useful if he were to review what Directors had indicated in terms of guidance for the staff, especially the areas where there was clarity and where there was not. First, there was clear agreement on the apex of Ms. Lissakers's hierarchy of issues that surveillance ought to address. Everyone around the table had agreed that vulnerability to currency and balance of payments crises was a core concern, and that everything related to that had to be considered. Clearly, exchange rates and related policies to forestall such crises was the crux of what surveillance should be about.

There appeared to clear agreement on the issue that staff reports should be clear and straightforward in flagging situations where data deficiencies made it impossible to do the critical analysis, the Deputy Director continued.

There had also been some convergence of views on the core/noncore issue, the Deputy Director considered. All Directors had agreed on what was critically important, and there seemed to be some agreement on the need for flexibility. As Mr. Taylor had pointed out with his example of lagoon pollution in a small island economy, it was important to consider issues that were critical to the macro economy and the balance of payments of the country.

There was also some agreement on the need to bring in the work from many different relevant sources—other agencies, other international financial institutions, and from elsewhere in the Fund—into the surveillance process, whenever the results of that work indicated that something was directly and significantly related to macroeconomic stability in the country, the Deputy Director stated.

There were two other areas where views remained unsettled and where further consideration was required, the Deputy Director related. First, there had not been much clear guidance on how to resolve the tension between candor and critical reporting on the one hand, and transparency on the other hand. Second, many different views had been expressed on consultation cycles. Indeed, there appeared to be cycles in the Fund's discussion of consultation cycles. The current discussion was reminiscent of the discussions leading up to the introduction of the bicyclic procedure in the mid-1980s. However, in those earlier discussions, it had been consistently maintained that larger countries that had a systemic impact should remain under the annual consultation procedure. The bicyclic procedure had been introduced in 1987 with 23 countries under the procedure. At that time, it had been generally considered that no one could object to having the Nordic countries under the bicyclic procedure, as they had been well-managed and stable for years. However, it was clear that that procedure had distracted Fund surveillance and had hampered the Fund's ability to identify the emerging Nordic banking crisis that occurred between 1988 and 1993. It was interesting to recall that the bicyclic procedure had been abandoned in 1993. Clearly, there remained a clear tension between the Fund's resources and goals, and it would be necessary to return to the matter to consider the issues more carefully.

Ms. Lissakers considered that the Deputy Director of the Policy Development and Review Department had misconstrued somewhat the tenor of the discussion. A choice between annual and biennial surveillance consultations had not been posed. In fact, what had been suggested was more of a hybrid, in which there would be, in some sequence, a comprehensive consultation and then a more targeted, limited consultation.

On the question of the risks of having a review only every other year, the Nordic example had been held up repeatedly by the staff as a reason not to pursue that procedure, Ms. Lissakers continued. However, given the nature and coverage of Fund surveillance at that time, it was unlikely that the Fund would have been able to detect the emerging Nordic banking crisis even if there had been annual consultations. At that time, Fund surveillance did not review the banking system of countries.

Mr. Esdar considered that it was inadvisable to state that one of the Fund's core concerns was only the prevention of balance of payments crises. There were many members that experienced balance of payments problems without an immediate market crisis. In that regard, it was better to view the Fund's mandate as ensuring the balance of payments sustainability of members.

With regard to the consultation cycle, it was somewhat misleading to frame the issue merely in the context of either the 12 month or 24 month cycle, Mr. Esdar said. Rather, there should be more continuous surveillance, and the annual consultation should be more focused and streamlined. The more comprehensive consultation could occur every two or three years.

Ms. Lissakers said that she agreed with Mr. Esdar's comments on the question of balance of payments crisis prevention. While she had argued for a hierarchy of concerns and what should be at the apex, that did not mean that all other issues should be downplayed in the Article IV surveillance. However, it was important that, in countries where the balance of payments was of critical relevance, such issues should be treated as a priority, rather than addressed in passing or not at all.

Mr. Mirakhor remarked that, in response to the Deputy Director of the Policy Development and Review Department's summary statement, no Director had opposed the idea of returning every country to the annual consultation cycle, as required by the Articles of Agreement. Rather, the discussion had focused on the content and composition of the surveillance reports.

Mr. Shaalan said that he was also surprised by the comments made by the Deputy Director of the Policy Development and Review Department, because there appeared to be a clear consensus on the need to return all countries to the annual cycle.

Mr. Taylor also considered that there was widespread agreement that there should be annual consultations of some kind for all members. Nevertheless, there appeared to be a need for an ongoing discussion about the nature of the contact. Some speakers, such as Mr. Mirakhor and the Acting Chairman, thought that there should be a comprehensive Article IV each year. But there were others who would like to be more targeted in terms of the circumstances that may apply, and also more experimental in the way in which the consultation was done.

On the issue of candor and transparency, there was some progress in identifying a dilemma that many chairs had not thought existed six months ago, Mr. Taylor continued. The issue would need to be considered further in the period ahead.

Mr. Chelsky said that he would add one thing to the Deputy Director of the Policy Development and Review Department's list of things on which there was a convergence of views, namely the need to provide in staff reports more explicit links why noncore issues, such as the environment or military spending, were relevant for the macroeconomic situation.

Ms. Lissakers remarked that Mr. Wijnholds had made a number of interesting proposals on how to disseminate Board guidance on surveillance issues to the staff.

The Deputy Director of the Policy Development and Review Department said that Mr. Esdar was correct to say that, while seeking to avert balance of payments crisis was important, the core requirement of the Fund was to address the sustainability of the external position.

He was pleased to note the consensus on having all countries on the annual consultation cycle, the Deputy Director continued.

On Mr. Wijnholds's proposals, he had addressed most of those in his opening remarks, the Deputy Director recalled. The idea of clear and consistent basic tables to be included in each staff report was useful, as was the proposal for a consolidated manual on Board guidance to staff on surveillance. On the question of a vulnerability supplement, the recurring questions about transparency and candor arose. On the scheduling of missions to meet the authorities' cycle so they could have maximum impact, while that idea was interesting, it was important to recall that the consultations needed to be scheduled so that they were sensitive to the Board's rhythm.

The Economic Counsellor and Director of the Research Department recalled that there was no legal requirement in the Articles of Agreement for an annual consultation. There was a decision of the Board that, in principle, the consultation should be on an annual cycle.

The Acting Chairman made the following summing up:

> Executive Directors welcomed the opportunity to review the experience with surveillance since the 1997 Biennial Review of Surveillance and to reflect further on the conclusions of the external evaluation of surveillance. They regarded the surveillance review as part of the Fund's

evolving effort to adapt its surveillance to reflect the implications of globalization and the growth of international capital markets. In this connection, Directors observed that a complex agenda of initiatives designed to strengthen the architecture of the international financial system has been put in place in response to the crises in emerging market countries since the mid-1990s. These initiatives, including in the areas of standards and codes, the strengthening of financial systems, data provision, and transparency, will have profound consequences for the conduct of Fund surveillance. Directors noted that the results of pilot projects under way in several areas will also have to be carefully assessed, as they will influence the future course of surveillance. Directors broadly agreed that Fund surveillance will be the central mechanism through which the results of much of the work on strengthening the international architecture will come together. However, they observed that the modalities for bringing the outcomes of the various initiatives under way into surveillance remain to be identified, and the important issue of how to draw on the expertise and resources of other institutions needs to be addressed. Directors noted that many external fora have made proposals for the conduct and coverage of Fund surveillance; these will need to be taken into account by the Board in providing guidance to the staff, and to ensure that the thrust of surveillance remains focused on its main objectives.

While the work on new initiatives has been under way, Directors were encouraged that progress is being made in strengthening surveillance activities in important areas, in line with Board guidance. These areas include the treatment of exchange rate policies, the increasing coverage of financial sector and capital account developments, and the assessment of external vulnerability, in particular for emerging market countries. Several Directors considered, however, that continued efforts remain necessary to adapt surveillance to the new global realities and to the evolving role of the Fund. Directors noted that the ongoing strengthening of surveillance has drawn on, and benefited from, the recommendations made by the external evaluation report on Fund surveillance. Some Directors suggested that the articulation of an action plan (as was requested at the Board discussion of the external evaluation report on surveillance) would help spell out more clearly the Fund's ongoing response to these recommendations; others recognized, however, that the articulation of such a plan will need to reflect the scheduled discussions of the many initiatives under way in the areas noted above.

Directors welcomed the systematic analysis in the staff paper of the coverage of core and noncore issues in Article IV staff reports(an area of much focus in the external evaluation of Fund surveillance. Most Directors considered that this analysis indicated that the coverage in Article IV staff reports of core issues (notably exchange rate policies and their consistency with macroeconomic policies, financial sector issues, the balance of payments and capital account flows and stocks, and related cross-country themes) has been broadly appropriate. In the period under review, Directors noted that staff has been selective in covering noncore issues, applying "macroeconomic relevance" tests(i.e., covering noncore issues in most cases only when these have a direct and sizable influence on macroeconomic developments(and they believed that macroeconomic relevance remains a pertinent test for the inclusion of issues in Article IV staff reports. Many Directors suggested that staff reports should include the rationale for the coverage of noncore issues in terms of their macroeconomic relevance. Directors observed that, in parallel with the rapid integration of international financial markets, capital account and financial sector issues have been added to the set of core issues in recent years, and that, given continuing changes in the global economy, the set of issues considered to be core is likely to keep evolving. While some Directors preferred drawing a clearer distinction between core and noncore issues, many others saw a hierarchy of concerns relevant for Fund surveillance: all issues related to external sustainability and vulnerability to balance of payments or currency crises will continue to be at the apex of this hierarchy. These latter Directors also recognized that the hierarchy of issues could vary over time and from country to country, with greater scope for overlap with other international agencies on issues further down the hierarchy. It was noted that the Fund did not have the breadth of expertise and experience necessary to cover many areas that, while outside traditional core areas, may at times be critical to a country's macroeconomic stability. On such issues, it will be essential to draw on the expertise of other institutions. Thus, surveillance teams should be aware of the work being done on a country in the other institutions, and could feed the results of this work into the surveillance process, whenever they were relevant to the Fund's core concerns.

On exchange rates, most Directors observed that surveillance over exchange rate policies has been strengthened and better focused, but, while recognizing a member's prerogative to choose its own regime, they stressed that an assessment of both the exchange rate regime and the exchange rate level is to be made in all cases. Directors welcomed the use of more sophisticated analytical techniques and the greater candor of staff assessments and policy advice, and recommended, in general, that the use of these techniques be spread to a greater range of countries. However, some Directors cautioned that explicit judgments in staff reports on either the exchange rate level or the exchange rate regime could, in some situations, risk an undue and disruptive influence on markets. These Directors suggested that where there are such risks, the views of staff should be presented to the Board orally or through some other mechanism. It was acknowledged that the potential trade-offs between transparency and candor would have to be kept under review, especially in the context of the pilot project for publication of Article IV staff reports.

Directors noted the greater emphasis on financial sector soundness and capital flows in Fund surveillance, and also the inclusion of vulnerability analysis in bilateral surveillance for some countries, particularly emerging market economies. Surveillance in these areas has been deepened, supported by the collection of more comprehensive and timely data relevant for the assessment of vulnerabilities.

Directors emphasized that Article IV consultation reports should contain clear and candid information on the quality of data available to staff for the conduct of surveillance, with attention being drawn clearly to the gaps or deficiencies in data that hamper analysis. In particular, most Directors thought that for effective diagnosis of financial vulnerabilities and incipient crises, all countries vulnerable to large capital account swings should provide high-quality and timely information on the usability of reserves, on short-term debt, and on developments in market sentiment. Directors looked forward to the forthcoming Board discussion on external debt and reserves with a view toward making further progress in this area. Some Directors saw scope for standardizing the data requirements and the nature of the vulnerability indicators to be reported and for the systematic use of alternative scenarios and stress tests for member countries.

Most Directors agreed with the current selective approach to the dissemination and use of early warning system models, given the state of the art in this area as well as the sensitivity and imprecision of the results. They encouraged staff to discuss the results of EWS models with country authorities, and to keep the Board informed of these discussions. They observed that actual currency crises had occurred in only about half the cases in which EWS models would have issued warning signs, and thought that this suggests that the results of these models have to be tempered with a good deal of judgment and, in any event, used selectively and carefully. Directors supported stepping up collaboration with the World Bank in the analysis of corporate sector vulnerability, with a view toward identifying useful operational indicators. They encouraged staff to continue to look for signs of linkages between potential weaknesses in the corporate sector and external vulnerability, following up, if warranted, on a case-by-case basis.

Directors welcomed the increasing attention paid to cross-country issues and policy interdependence, and emphasized that the Fund has to play a key role in developing and disseminating information and judgments in these areas. Some Directors, while noting the progress, stressed that such issues need to be more systematically included in bilateral surveillance. The Fund's increasing participation in regional fora was thought to be an appropriate way to advance this work, these Directors noted. A few Directors called for adoption of more systematic arrangements for discussions with regional institutions of currency unions such as WAEMU, CAEMC, and the ECCB, as in the case of EMU.

Directors were broadly satisfied with the focus of multilateral surveillance as carried out in the WEO and ICM reports, and the WEMD sessions. They called for continuation of periodic assessments of exchange rates and current accounts, and of early warning system indicators, the discussion of risk, and the use of alternative scenarios in the WEO which has contributed to a sharpening of the analysis. While welcoming recent progress, Directors called for continued efforts to better integrate Fund multilateral and bilateral surveillance activities. Some Directors also encouraged continued integration of capital market developments and views of market participants in bilateral surveillance work.

Directors stressed the importance of maintaining the uniformity of treatment of member countries, and emphasized that the principle of annual consultations constituted the cornerstone for the continuity of Fund surveillance. Nevertheless, in the context of strained staff resources, most Directors supported a degree of flexibility in consultation frequency, mission size, and documentation in order to ensure an effective focus of surveillance(provided that an adequate level of contact is maintained with all countries. Some Directors suggested that the Fund could experiment further with even more flexible procedures, especially as regards the content of Article IV consultations and the frequency of comprehensive staff papers. Several Directors expressed concern about the rise in Article IV consultation delays. Directors agreed that indicators of the use of budgetary resources for all surveillance should be closely monitored in the period ahead and should serve as an important input into operational budget decisions.

With a view to facilitating the communication within the Fund of the Board's guidance on surveillance, it was agreed that all guidance notes and summings up relating to surveillance should be consolidated into a single surveillance manual.

Directors have expressed a number of interesting views on issues central to Fund surveillance, such as provision of data to the Fund, the further development of standards and codes, FSAPs/FSSAs, and the incorporation of the work on standards and codes into bilateral surveillance. Directors acknowledged that any changes in the practice of surveillance will have to be evaluated in the context of the broader issues of the evolution of the role of the Fund in the international financial system. The Board will have an opportunity to reflect carefully on many of these issues in the next several months. Following the discussions on these various initiatives, the staff will prepare a follow-up paper, possibly in advance of the fall 2000 meetings, drawing on the guidance provided by the Board. This paper could assess the implications of these various initiatives for surveillance, consider whether any amendments to the principles and procedures of surveillance may be needed, and assess the implications for operational guidance to staff. The paper would also provide an opportunity to integrate the points for action emerging from the external evaluation with the many initiatives already under way to strengthen Fund surveillance.

The Acting Chairman remarked that a draft decision formally concluding the review of the 1977 surveillance decision would be circulated soon for approval on a lapse-of-time basis.

2. ARGENTINA—STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on Argentina's request for a Stand-By Arrangement in an amount equivalent to SDR 5,398.61 million (EBS/00/20, 2/14/00; Sup. 1, 2/24/00; and Sup. 1, Cor. 1, 3/10/00).

Mr. Zoccali submitted the following statement:

> Since the second half of 1998, the Argentine economy has been subject to a succession of significant adverse external shocks that included the devaluation of the Brazilian real in conjunction with a strengthened US dollar, low export commodity prices, and generally tighter conditions governing access to international capital markets. These factors coincided with the uncertainty that normally accompanies a tenured administration coming to an end, in December of last year. This combination of factors translated, in 1999, into a contraction of real GDP of 3 percent and of the GDP deflator by 2.4 percent, impacting negatively on employment, investor confidence and, more specifically, on performance under the arrangement with the Fund, particularly during the fourth quarter. As a result, doubts surfaced again in some quarters regarding the sustainability of Argentina's chosen policy framework.
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> Despite this unfavorable backdrop, the impulse of fiscal policy in 1999 remained roughly neutral, Argentina maintained its open economy stance and the confidence of domestic depositors in the soundness of the domestic banking system was unshaken, resulting in further but moderate deposit growth. Similarly, the second-year of the Fund supported EFF Arrangement was kept precautionary while serving to focus the political debate during this volatile period on the remaining structural weaknesses impinging on the consistency of macro-economic policies and the sustainability of the strategy for social development. The country's strengthened democratic institutions and the widespread support obtained by President de la Rua in the election, provided an opportunity for decisive corrective action, that was immediately seized after taking office in mid-December.
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> The new administration is firmly committed to creating the conditions for sustainable economic recovery that is essential to reduce unemployment and poverty in a lasting manner, and to maintain price stability within the rules-based convertibility framework. The legislation already enacted evidences the determination to ensuring inter-temporal fiscal solvency and to reducing Argentina's external vulnerability. It includes congressional approval

of a tight budget for the federal government in 2000, an investment-neutral tax package, a transitional agreement with the provinces on revenue-sharing and fiscal consolidation, the elimination of industrial and agricultural promotion going forward and a substantive labor market reform that cleared the Lower House, and has a good chance of becoming law by end-March. Moreover, the fiscal targets of the program, aimed at achieving overall fiscal balance by 2003, are fully in line with the Fiscal Responsibility Law enacted last August.

The dialogue between my authorities and Fund staff and management has been frank and highly valued, facilitating agreement on a new three-year Stand by Arrangement, which will be treated as precautionary. Fund endorsement of the new economic program, covering most of the present term of office, is viewed as the centerpiece of the strategy for rebuilding confidence and the rapid growth which Argentina is capable of delivering. In keeping with past practice in the area of transparency and to give a clear signal of ownership, the memorandum of economic policies, together with the quantitative performance criteria table, and the technical memorandum of understanding have been posted in the government's web site in both Spanish and English. My authorities also agree to having the same information disseminated on the Fund's web site.

The staff report on Argentina's request for a Stand-by Arrangement (EBS/00/20, Sup. 1) provides a detailed and well-balanced description of recent economic developments. My authorities also concur with the general thrust of the staff appraisal. Consequently, I will refer to a few points that warrant special emphasis.

The recession bottomed out in July of 1999 and was followed by five subsequent months of sustained growth of industrial production and construction activity. Fourth quarter growth figures tend to indicate a statistical floor for projected real GDP growth in 2000 of 1.6 percent. In January, industrial activity showed a continued but cautious recovery, with industrial production rising on a seasonally adjusted basis by 3.5 percent (y-o-y). The CPI in February remained flat despite the effects of higher fuel prices and the introduction of new taxes. Available indicators of consumer confidence confirm a trend of slowly returning optimism. The December and January trade figures provide the clearest evidence of forward momentum. Exports in these months grew 5 and 17 percent, respectively, (y-o-y) and imports showed positive growth for the first time since August 1998 (y-o-y). An extrapolation of trade flows for 2000 based on this trend would point to a much improved trade position for the year. My authorities are confident that strong export growth will contribute in 2000 to reduced external deficits, in particular in the trade account, when compared to their 1999 levels. The trade deficit for all of 1999 declined to $2.2 billion, or some 55 percent lower than in the previous year, even after adjusting for the significant deterioration of export commodity prices from already low 1998 levels.

Looking ahead, the improving external environment, that includes a pick-up in regional economic activity and more favorable conditions of access to external financing, make the 3.5 percent real GDP growth assumption in the program conservative. The moderate pick-up in consumption in the first two months of this year has been accompanied by a higher rate of domestic savings. This together with the improving terms of trade, the recovery of exports and the real effective exchange rate, and the lowering of the country-risk premium, lends support to the view of my authorities that a 4 percent real rate of growth for the year, requiring seasonally adjusted quarterly growth of only one percent, remains achievable. At the same time, substantial spare capacity, a relatively high rate of unemployment and declining public utility rates from further deregulation make for subdued price and wage pressures during the year.

A well-sequenced structural reform agenda forms the basis for addressing the more challenging medium-term economic issues facing my authorities, namely, the quality and pace of fiscal consolidation, securing the necessary financing, continuing the sound development of the domestic financial sector, and enhancing competitiveness. I will focus on each of these issues in turn.

In the present circumstances, whereby Argentina is emerging from recession, my authorities are fully aware of the risks in advancing fiscal policies which, on a consolidated basis, impart a contractionary impulse to domestic demand of around 1.7 percent of GDP for the current year. The scope of the effort is, indeed, significant with across the board spending cuts, including on wages, goods and services, social security benefits, transfers and capital spending. Recently, the executive branch implemented a significant selective reduction of expenditures that covers, inter alia, the elimination of 32 government secretariats and agencies, the retrenchment of contractuals and the slashing of staffing of the state intelligence network by 35 percent.

On the revenue side, the tax pressure was increased through the elimination of exemptions, the widening of the base of the VAT, and from hikes in personal income and wealth taxes, as well as in excises. The projected reduction of employers' payroll tax was also suspended. My authorities are convinced, however, that the negative impact on consumption that may be attributable to the fiscal effort will be more than compensated by the stimulus on domestic demand from the reduction in the country risk premium and interest rates, keeping in mind that the new budget is in compliance with the Fiscal Responsibility Law. The reduction in Argentine bond spreads is already taking place. Moreover, the increased tax pressure is viewed by my authorities as an emergency response. As repeatedly stated, once the bill presently in

Congress aimed at attacking tax evasion begins to bear fruit, the government is committed to reducing distortive taxation consistent with the requirements of a more competitive market economy as a result of globalization. In any event, the 19.7 percent of GDP level of tax and non-tax revenue projected for this year is still relatively low by international standards.

It is worth highlighting that the present economic program attempts to reign in the overall fiscal deficit to ensure that the adjustment effort of the federal government will not be diluted by performance at the provincial level. In this regard, the transitional Federal Accord with the provinces ensures that the higher tax revenues expected from the new fiscal package and the projected recovery of activity will serve to consolidate the federal accounts rather than just augment provincial transfers, as would have been mandated under the existing revenue sharing pact. The new agreement commits the federal government to maintaining tax transfers to the provinces at roughly the same level of 1999, with an averaging formula to moderate any subsequent increase. Looking ahead, the federal and provincial governments have been negotiating for some time a more permanent reform of the revenue sharing system, which is expected to be in place as from 2002. The main objectives of the reform are clearly described in the staff paper. The creation of the Federal Council should pave the way for the provinces to agree on the horizontal distribution of revenues and impose conditional assistance on themselves.

In addition to the Federal Accord commented above, the program under the requested Stand-By Arrangement introduces, for the first time, a performance criterion for end-2000 on the change in the debt of the consolidated public sector, including the provinces. In this context, the combined deficit of the provinces this year is projected to be halved with respect to the level of 1999, to the equivalent of 0.7 percent of GDP. Despite constitutional constraints which preclude the imposition of a given pace of fiscal adjustment on the provinces, the national government will exert an important influence on their behavior, particularly on those that are affected by a substantial debt overhang. The federal government has already entered into individual, collateralized refinancing agreements with seven provinces. Their provincial debt maturities falling due in 2000 and 2001 will be refinanced in a phased manner subject to provincial compliance with specific quarterly fiscal deficit and debt level targets throughout the period. The agreement with the initial group of provinces involved would reduce their combined budget deficit from $ 622 million in 1999 to $ 196 million this year. In addition, all the provinces have accepted, in the context of the Federal Accord, to introduce fiscal responsibility laws modeled on the one already in force at the national level. Eight provinces have already enacted such laws. Moreover, the government has indicated that it will use its authority over provincial foreign-currency borrowing to foster federal compliance with the performance criteria under the program.

The recent release of January fiscal figures, showing a deficit of $ 588 million, and the estimated tax revenue data for February, indicating a 0.4 percent fall relative to the same month of 1999, may at first glance disappoint some observers expecting improved figures as a result of the new tax package. However, the sluggish pace of tax collection during the first quarter was already anticipated in the program, which contemplates a $ 2.25 billion deficit for this period, and evidences the prudent assumptions underlying its design. The fact is that while the modest increase in monthly provincial transfers will operate from the beginning of the year, the effect of many of the measures included in the fiscal package will not be reflected in the revenue data until later in the year as clearly indicated in Box 7 of the staff paper. Regarding the possible adverse effects of the so-called moratorium on tax compliance, however, some of its operational features should be kept in mind. First the elimination of late interest and fines to facilitate the normalization of arrears on taxes and social security contributions comes at a price. Eligible obligations still accrue interest at a rate which covers the cost of government financing. In addition, the installment plan stipulates an interest rate of around 10 percent on deferred obligations which is highly positive in real terms. Lastly, two other important existing mechanisms of tax performance mentioned in Box 6 have been eliminated. At the same time, it should be noted that despite an all out effort to reduce tax evasion, that includes measures to speed up tax collection and strengthen enforcement, the projections for 2000 make no allowance for additional tax revenue from efficiency gains in administration.

The lingering perception of Argentina's external vulnerability has in recent months tended to focus attention on the size of its gross financing requirement, particularly of the federal government, as a result of adverse cyclical conditions in the region as well as domestically. The subsequent improvement in external conditions and the qualitative shift in structural fiscal policy, set within a more comprehensive quantitative framework to increase public sector savings, are important new elements in the strategy to secure needed public sector financing while increasing the availability and lowering the cost of financing for private sector borrowers. These have already been reflected in Standard & Poors' upgrading, last February, of its outlook on the ratings of the Republic of Argentina to "stable" and in the renewed interest in Argentine debt placements resulting in increased size of recent bond issues and declining spreads, in consonance with the more favorable trend towards lower emerging market risk spreads more generally. Argentina's debt transactions of the past six weeks have secured some 30 percent of total requirements for the year, extending coverage of all the maturities of the federal government through next June.

My authorities remain convinced of the merits of an active liability management policy and of the importance of the effort to offer market participants greater predictability and transparency regarding future Argentine deals and of greater global coordination to facilitate the voluntary involvement of the private sector in the country. Periodic updating and dissemination of the calendar of scheduled auctions and placements of Treasury bills and bonds and limited reopening of previous issues are deemed important tools in this respect. In addition, their strategy relies on continued smoothing of the debt amortization schedule, to avoid heavy maturity concentration and to reduce yield-curve differentials, among others through imaginative debt exchanges. Similarly, they are limiting short-term public borrowing, including through strict adherence to budgetary limits for the recognition of past debts, to further lengthen public debt maturities from the already comfortable average of 7.5 years at end-1999. Privatization also remains a residual tool to facilitate meeting the objectives of the financing program. The diversification in terms of financing instruments and markets, the large component of foreign direct investment, the increasing role of institutional investors in the growing domestic market, should help to reduce the market perception of Argentine risk going forward. Lastly, when assessing the ability of Argentina to secure financing or the significance of still unfavorable debt service indicators, the net foreign exchange position of its residents vis-à-vis the rest of the world should not be downplayed, keeping in mind that according to staff's figures this would reduce total foreign exchange exposure from the equivalent of over 50 percent of GDP to less than 10 percent.

The domestic financial system is projected to intermediate in 2000 some US$ 14 billion in net terms. The sustained increase in the level of monetization, and of domestic deposits has undoubtedly been facilitated by the predictability of Argentina's monetary arrangement and its delivery of price stability. At the same time, this outcome can also be attributed to the resoluteness of my authorities in revamping and adapting the prudential and supervisory framework, that conforms not only to international standards and best practices but also to the higher volatility of Argentina in today's global economy. Prudential norms are uniformly being applied, including to Banco Nación (BNA) by an autonomous central bank, which exercises both regulatory and supervisory responsibilities. More specifically in the case of BNA, internal measures taken limiting loan concentration to large borrowers should be seen as a mean to diversify risks not as an attempt to direct sectoral credit, keeping in mind that there are no price, interest rate, or exchange controls in Argentina. My authorities have no intention of influencing the market-based process of credit allocation. A number of additional factors help to explain the confidence of depositors and the robustness of the banking system throughout the 1998/99 cyclical downturn. These include, the fact that there were no bank failures in 1999, that comprehensive disclosure of asset structures, risk exposure and capital adequacy to balance sheet and off-balance sheet risk has introduced market discipline, that the process of bank consolidation remains market-based and orderly, with some 60 percent of deposits in foreign financial entities, and that the banking system's foreign exchange reserves, including the US$ 7 billion contingent repo facility with foreign private banks, cover over 44 percent of broad money.

In this same vein, while the switch-over to privately administered pension funds adds during the transition some one percent of GDP per year to the federal government deficit, there can be no doubt that it has also contributed to accelerating the development of the domestic capital market. Securitization is now being ushered in to broaden credit availability and lower the high costs, particularly for small and medium-sized firms, in a still fragmented financial market. The planned financial sector reforms are well described in the staff paper, suffice it only to note that my authorities are working actively to further strengthen bank supervision, to improve coordination of the regulatory frameworks covering the other institutions operating in the domestic capital market, in recognition of the growing importance particularly of pension and mutual funds and insurance companies, to develop futures markets and to strengthen the trading and settlement systems for securities. Overall, the continued development of the financial industry is considered critical for the effort to sustain equitable non-inflationary growth in Argentina.

Regarding external policies and prospects, it is worth recalling that competitiveness concerns have been voiced in the case of Argentina since adoption, in 1991, of the currency board framework. Domestic market participants adapted quickly to the new circumstances and began to focus on ways to improve productivity and competitiveness. External observers, on the other hand, have been more inclined to highlight the risk of a break in the regime owing to the constraints associated with the rigidity of the nominal exchange rate. Doubts and fears concerning the latter were in fact more prevalent in some quarters outside Argentina than within. Market concerns about the sustainability of the exchange rate regime noted in paragraph 67 of the staff appraisal should be seen in this light.

My authorities' commitment to the economic policy framework in place does not relate to the current circumstances or stem merely from the consequences of abandoning the regime, as is implicit in the staff paper. Rather, the convertibility framework is embraced because of its multiple proven advantages, including the fact that it accommodates well the currency preferences of the public. It not only provides a firm anchor for conducting macroeconomic policy, in particular by eliminating inflationary expectations and increasing awareness of the need to maintain fiscal discipline, but it also forces greater openness and transparency in the economy. Moreover, the present framework has created the climate for a constant improvement of productivity and renewed private investment. The rapid incorporation of new technology and the widespread deregulation have, in turn, helped to sustain improvements in competitiveness. In sum, my authorities rule out a change in Argentina's exchange rate regime as an economic policy option.

It is important when assessing competitiveness and export performance to do so in a medium-term perspective and not merely by focusing on developments in 1999. Last year's Article IV Consultation report brings out the fact that between 1993 and 1998 Argentina exports more than doubled in real terms. In addition to the adverse external shocks already alluded to in 1999 exports fell by 11.8 percent in value terms. This, however, was explained almost entirely by the drop in commodity prices. These numbers should help alloy the concern that there is an inherent inability in the present system to deliver external viability.

Notwithstanding this, the new administration has responded to the seriousness of the challenges faced during 1999 with several policy initiatives aimed at strengthening the competitive edge of the Argentine economy. The labor reform proposal already commented extensively in the paper should contribute to employment generation while maintaining wage moderation. In addition, a draft law is also being discussed in the Congress to support small- and medium-size enterprises inter alia by helping to improve the terms and level of their access to domestic credit, presently hampered by informational asymmetries, and their ability to access foreign markets. Moreover, the drive to bring the price of non-tradable services more in tune with international levels is taking on renewed emphasis through a number of initiatives aimed at promoting competition in sectors, which have enjoyed until recently quasi-monopoly profits following Argentina's widespread privatization program during the last decade. Significant reductions in utility rates in telecommunications and energy have already been secured. Looking ahead, it is realistic to expect a recovery of exports during this year as the result of faster growth in trading partners, a lowering of the real effective exchange rate of the peso, higher commodity prices and the continued productivity gains aided by increased competition and more flexible labor markets resulting from the policy framework in place.

In sum, my authorities are confident that the comprehensive package of short-term adjustment measures and structural reforms that make up their medium-term economic program are realistic and fully consistent with the objective of maintaining stable financial market conditions and strong and more equitable growth in Argentina. In that light, the support of the Executive Board for the requested Stand-By Arrangement constitutes the linchpin for their fully owned effort to establish confidence.

Mr. Shaalan submitted the following statement:

We welcome this request for a Stand-By Arrangement by Argentina. The coincidence of adverse external developments and weak policy performance in the run-up to the recent presidential elections have been responsible for a significant economic setback in a country that has otherwise enjoyed largely exemplary performance over the past decade. The program before us provides a solid base for reversing the recent deterioration in the fiscal account, as well as debt dynamics, while laying the foundation for sustainable growth. This program, however, is not without downside risks, as the staff's medium-term sensitivity analysis clearly shows. Thus, the authorities are operating with a very narrow room for maneuver, where higher interest rates or slightly lower export growth could have a significant impact on the baseline scenario. Under such circumstances, any slippages could engender disproportionate market reaction.

Under Argentina's Currency Board Arrangement, fiscal policy is the key tool available to the authorities for the purpose of discretionary macroeconomic policy. Accordingly, the program is appropriately centered on a strong reduction in the fiscal deficit, totaling 3.5 percent of GDP over the program period. The strength and heavily front-loaded nature of the consolidation process may, in principle, raise questions on the possibility of unduly restraining the nascent recovery. However, once fiscal consolidation measures have reduced market uncertainty, as well as pressures on interest rates, the consolidation process could be a factor contributing to an accelerated recovery. In this connection, it is well to note that past experience suggests that Argentina's fiscal accounts also need to maintain sufficient room to deal with unexpected shocks. Therefore, we are pleased to note that a counter-cyclical fund has been established under the Fiscal Responsibility Law.

The fiscal retrenchment process clearly requires action on a multiplicity of fronts. A key objective of the fiscal consolidation process should be to promote growth in national savings, which is particularly important in view of the level of the current account deficit. To this end, revenue enhancement plays a crucial role. The overall level of taxation in Argentina, as measured by the revenue to GDP ratio, is not particularly high. Enhancing revenue will depend in part on increasing tax rates, as well as broadening the tax base. The envisaged measures, outlined in the staff report, represent significant steps towards achieving both goals. At the same time, the reduction in tax distortions, should help lay the groundwork for sustainable growth. Another key element of the revenue enhancing process is the strengthening of tax collection and administration. The partial tax moratorium will increase revenues in the short term, as some more durable measures to enhance collection are implemented. It is important, however, to avoid resorting to such moratoria in the future, which past experience suggests carry significant moral hazard risk.

Expenditure cuts are also playing a crucial role in the ongoing consolidation effort. Looking ahead, however, the room for further cuts appears to be diminishing. Therefore, the importance of strict adherence to the agreed limits on expenditure growth cannot be over-emphasized. The relatively more limited room for expenditure reductions again highlights the need for rapid progress in revenue enhancement.

The success of the fiscal consolidation effort will also hinge on strengthened cooperation and coordination between the federal authorities and the provinces, which has been a long-standing issue. In this connection, we welcome the inclusion of the provinces in the ceiling on consolidated public sector debt under the program. We are also encouraged by the government's intention to use its legal power to ensure that foreign currency borrowing by provinces is consistent with a significant improvement in their finances. The recent replacement of the revenue sharing system between the central government and the provinces, with a system based on fixed transfers, is also a welcome departure from past practices. This should strengthen financial discipline by all parties. Given that this agreement is set to expire in 2002, we would hope that the authorities would spare no effort in working towards a permanent solution at an early date. Reaching an agreement well before the expiration date can only help allay concerns regarding the long-term prospects for public finances.

A sustained fiscal consolidation effort is essential to bring Argentina's debt and debt service to manageable levels. The outlook over the near term, however, is not very comforting. Further increases in the debt level are expected as a result of court rulings in favor of the recognition of certain liabilities. The exact magnitudes are still not certain, neither is the timing. Furthermore, particularly under a currency board regime, there is ultimately little difference between external and domestic debt. When considered simultaneously, the combined external and domestic debt service obligations of Argentina are at a level that argues for stricter limits on public sector borrowing, particularly by the provinces.

Turning to monetary and exchange rate policy, we fully concur with the view shared by the staff and the authorities that a departure from the current regime will entail considerably more costs than benefits. This is particularly true given the existing high level of dollarization in the economy. Market perception of the Currency Board Arrangement, however, had vacillated over the years, and the peso continues to be subject to considerable pressure sporadically. Pressures tend to emanate from two concerns. First, occasional concerns on the strength and solvency of the financial sector during tight monetary conditions. Second, the sustainability of the Board arrangement given the continued market rigidities in the economy, and the difficulties in reversing declines in competitiveness.

On the first concern, the financial sector has been subject to considerable pressure in the past, and wide-ranging reforms were implemented since the mid-nineties. Nevertheless, experience over the past year suggests that further efforts will be needed to ensure that the banking system is flexible enough to withstand the occasionally demanding conditions of very tight liquidity. Against this background the recent proposed changes to the central bank's charter to enhance preventive mechanisms to help avoid bank failures is encouraging. We are particularly comforted that the proposed changes also pay due regard to minimizing moral hazard. The implementation of these changes should strengthen market confidence in the banking sector as a whole by bolstering the authorities ability to act quickly to isolate potential banking crises, before problems become more widespread.

In dealing with episodes of tight liquidity, where the financial system is under pressure, it is important for the authorities to proceed with great caution in exercising the room for maneuver they have in lowering the foreign exchange cover of the peso. Past experience suggests that such moves are interpreted as an activist monetary stance, and are not usually well received by the markets.

The second source of concern, namely the long-term sustainability of the currency board, is centered on the economy's external competitiveness, and it is precisely here that significant reforms are needed. This is all the more critical given the economy's very low export base and high debt service obligations. The recent real appreciation of the peso is worrisome, though we are heartened to see that some reversal is foreseen over the course of the year.

The staff paper contains a wide-ranging agenda of structural reforms aimed at enhancing competitiveness. Among these structural reforms, we would place particularly high emphasis on labor market reform, and we welcome the significant measures envisaged by the authorities under the program. Argentina can ill-afford the types of rigidities that currently prevail. Indeed, under a currency board regime the authorities need to endeavor to ensure that the labor market enjoys the maximum possible degree of flexibility. While we appreciate the difficulty of introducing reforms in this area, a more ambitious program will need to be formulated to ensure that the economy is on a sustainable footing for the long term.

Finally, the Argentine authorities do have a difficult task ahead. The speed with which the authorities moved to formulate a comprehensive adjustment and reform program following the recent elections reflects their high degree of commitment. We wish them every success in the period ahead.

Mr. Bernes submitted the following statement:

The Argentine authorities deserve to be commended for the speed with which they have tackled some of the pressing policy issues early in the new mandate. They are obviously sensitive to the fact that there is little room for complacency, and that many challenges still lie ahead. Owing in large measure to the demonstration of resolve, I support the proposed Stand-By

Arrangement for Argentina. The program should help to enhance the coherence of the policy framework and the macroeconomic flexibility required to support the Currency Board Arrangement, and in turn, help to solidify growth and employment prospects with low inflation.

The remainder of my statement offers some specific comments on selected aspects of the program, and concludes with a few thoughts on the proposed access under the SBA.

It is clear that fiscal consolidation and reform is critical for the success of the program, and along with continued improvements in the flexibility of the economy, this constitutes a central element in ensuring the viability of the Currency Board Arrangement. Cast in this light, the significant fiscal slippages that occurred in late 1999 were an unexpected disappointment, especially given that they followed the expression of specific concerns on this matter by a number of Directors at the time of the EFF's third review in mid-1999, and they occurred at a time when economic activity was apparently already rebounding.

The new administration is renewing the fiscal effort, however, and I am encouraged by recent developments, including: approval of the budget and the fiscal package; the so-called "federal commitment" provided by the provincial governments to the consolidation effort; and congressional approval of the Fiscal Responsibility Law.

Notwithstanding recent positive developments, I have concerns over a few elements of the proposed fiscal program. First, it is not evident to me that the programmed reduction in the consolidated public sector deficit over the 2000-2002 period constitutes an overly strenuous effort, especially in the context of real economic growth projected at close to 4 percent per year.

To illustrate my point, I think it could be useful to place Argentina's envisaged consolidation in an international context. Last week, the Board discussed the 1999 Article IV consultation with the United Kingdom, so I can start by pointing to policy adjustments undertaken in that economy, since they are still relatively fresh in our minds. When one looks at fiscal adjustment in the U.K., one sees that the authorities engineered a swing in the general government balance from a deficit of 5.1 percent of GDP in 1995 to a surplus of 0.5 percent of GDP in 1998, for an average annual adjustment of nearly 2 percentage points per year over the three-year period. A similar result was also achieved in my own country, Canada, where the general government balance was taken from a deficit of 5.6 percent of GDP in 1994 to a surplus of 0.8 percent in 1997, for an average annual fiscal adjustment in excess of 2 percentage points per year. By contrast, over the three-year course of this arrangement, Argentina's consolidated public-sector balance is programmed to improve by about 3.3 percent points of GDP, or only about 1 percentage point per year on average.

In the above examples, fiscal efforts achieved close to double the average annual consolidation, over the same time frame, compared to that envisaged in Argentina's program. In both examples, economic growth remained healthy while fiscal consolidation was pursued, unemployment declined, long-term bond yields fell, and current account balances improved.

Examples of strong and successful fiscal consolidation are not confined to major industrial countries. In Jamaica, for example, the primary balance of the public sector should reach a surplus of 10 percent of GDP in fiscal year 1999, up from 2.2 percent in 1997. Based on current policies, the staff projects the primary surplus will rise to 10.8 percent in 2000, for a total primary adjustment of 8.6 percentage points over 3 years. The public sector primary balance in Argentina's program, in contrast, is projected to improve by a little over 4 percentage points of GDP over the course of the 3-year arrangement.

Admittedly, such comparisons are oversimplified. Some obvious caveats spring to mind, including: on the one hand, differences in starting points for economic activity and unemployment, differences in the dynamics of borrowing costs, and differences in degrees of tax compliance; and on the other hand, differences in demands on fiscal policy imposed by different exchange-rate regimes.

Notwithstanding the many caveats, however, such a comparison can be useful to point out that a stronger fiscal consolidation effort is feasible, and has desirable consequences. On balance, therefore, I view the deficit-reduction targets incorporated in the program as a minimum effort, and I would strongly urge the authorities to use the opportunity provided by a new electoral mandate and the anticipated rebound in economic activity to outperform on deficit reduction. Furthermore, my authorities want to stress that in light of the importance of fiscal consolidation and reform, and given last-year's slippages, waivers for fiscal slippages under the proposed arrangement will not be granted lightly.

Second, like the staff, I am concerned about the risk of slippages in the provinces' finances. Spending over-runs at the provincial level contributed to the sharp deterioration in public finances in 1999. As well, the staff report emphasizes that the federal authorities will have to use the legally-mandated instruments very firmly to control the provinces' recourse to indebtedness. Both factors lead me to wonder about the extent to which the provinces feel a sense of responsibility for ensuring that their policies help to support macroeconomic adjustment in general, and reduce external vulnerabilities in particular.

In 2000, the staff report notes that the most important factor contributing to reducing the combined provincial deficit is to be a "wide-ranging effort by the...provincial governments to cut back spending". This is rather vague, and given the risks, I welcome the inclusion of end-2000 binding performance criterion on the ceiling of consolidated public sector debt including the provinces. It would also be sensible, to help alleviate the uncertainty posed by provincial fiscal policies, for the federal government to identify contingency measures that could be undertaken at the federal level should provincial fiscal programs go off track. Over the longer term, as the staff suggests, a more durable reform of the revenue sharing system with the provincial governments will have to be found.

Third, I concur with the staff on the regressive nature of the authorities' recourse to using tax moratoria in an attempt to improve tax compliance. Tax moratoria will only work if there is a credible threat to potential tax evaders that they will be caught and penalized at least as firmly as would otherwise be the case. The authorities' plans with respect to strengthening tax enforcement mechanisms are indeed welcome, but they will inevitably take time to operationalize. In the meantime, I would expect adverse effects on tax compliance. This is unfortunate.

I concur with both staff and the authorities on the inadvisability of attempting to devalue the exchange rate in the context of maintaining the Currency Board Arrangement. In and of itself, the chronic current account deficits over recent years may suggest that the exchange rate is overvalued, especially so following the depreciation of the Brazilian real. But it would be wrong to think that a sudden realignment of the exchange rate could be pulled off as a one-time event—in an attempt to improve competitiveness—followed by a return to a credible exchange-rate peg and the accompanying domestic price and expectations discipline.

As the staff report makes clear, under the Currency Board Arrangement, the needed improvement in the external accounts will have to be achieved through measures to strengthen competitiveness, increase labor-market flexibility, and increase national savings (including importantly a more robust fiscal consolidation effort at both the federal and provincial levels). In this sense, the existing monetary-policy framework is not without risks and implications. In all likelihood, short-term interest rates in the United States will rise further over the course of 2000, thereby raising Argentina's borrowing costs, and possibly constraining economic activity, which could adversely impact fiscal revenues and feed back into higher borrowing costs through higher risk premia. And Argentina's high external financing requirements, combined with a large external debt, already make it particularly vulnerable to shifts in market sentiment. But such risks can be mitigated, at least in part, if the authorities were to outperform the fiscal targets, and maintain or accelerate the momentum of structural reform.

On balance, therefore, I concur with the staff's assessment that the Currency Board Arrangement is sustainable, especially with the further implementation of appropriate macroeconomic and structural policies. From a longer-term perspective, however, a number of developments are likely to affect the balance of costs and benefits associated with the current monetary order. These include: the authorities plan to continue the process of economic integration and policy convergence with Mercusor; the constraints on fiscal policy brought about by the needed consolidation efforts and Fiscal Responsibility Laws; and the likelihood that commodity-price and other external shocks will continue to affect the Argentine economy differently from that of the U.S. In the past, the authorities have put dollarization into the spotlight as a potential tool for crisis management. But the longer-term implications of dollarization, and indeed of maintaining the current monetary order, will have to be kept under review in light of the developments noted above, as will assessments of potential alternative monetary orders.

There is no room for complacency on the structural reform front when operating under the constraints imposed by the Currency Board Arrangement. The authorities appear to be keenly aware of this, and I welcome the swiftness with which they have renewed the effort to undertake labor-market reforms, in particular, and the plans for further reform of the financial sector. I urge the authorities to press for passage of the labor reform bill without significant weakening.

One aspect of reform I am not comfortable with, however, is the intention to encourage credit allocation by state-owned banks. Here, I agree with the staff that the financial sector should be left to channel financial resources to productive activities based on market-based assessments of risk and return.

Finally, I would like to comment on the proposed access under the arrangement. I have no particular difficulty with granting a 3-year Stand-By Arrangement. Moreover, I support the proposed access of SDR 5.4 billion, but for different reasons than those forwarded by the staff. In my view, the proposed access is warranted given the following: (i) the authorities' ownership of, and commitment to, the reform process; (ii) the speed at which the new administration has begun to address some of the pressing policy issues; (iii) the authorities' intention to treat the arrangement as precautionary (indicating their preference to undertake the necessary policy adjustments and maintain access to international capital markets, while viewing Fund financing as a "last line of defense"); (iv) a credible history of treating programs as precautionary; (v) the institutional strength of the Currency Board Arrangement, and the program's aim to enhance the coherence of macroeconomic policies in support of it; (vi) the existing soundness of the financial system, and the planned financial sector reforms; and (vii) a history of good public debt management practices.

The staff paper advances three arguments in favor of large access under the SBA. These include: (i) the possibility that Argentina's financial needs could be substantial; (ii) the programmed adjustment is strong and front-loaded; and (iii) substantial financial support from the Fund will catalyze similar financial support from the private sector.

I have some concerns with the thrust of these arguments. First, with respect to (iii), it is true that the promise of significant financial support from the official sector will help to reduce the liquidity risk associated with holding Argentine assets, thereby helping to "bail in" private-sector investors. I am not sure, however, that I am comfortable with this line of argumentation. In the limit, with sufficiently large financial assistance, it may even be possible for the official sector to eliminate default and exchange-risk premia. But if we place too much emphasis on the financial catalytic effects of large official support packages, we run the possible risk of instigating a "rush for the exits" if the program were to go seriously off track, and if a suspension of the Fund's financial assistance were necessary, due to policy slippages.

Rather than working to reduce the risk side of the risk/return trade-off faced by investors, I would prefer that we focus more on boosting the return side, by striving first and foremost to have the catalytic influence of an IMF program work via the strength of the embedded policy adjustment. This would provide a more stable avenue to help entice investors to hold a program country's assets.

This leads to (ii), the argument that the program incorporates a strong and front-loaded adjustment. While the authorities have definitely moved swiftly in a number of very important areas, as noted above, I believe that there is scope for a tighter fiscal policy than is currently incorporated in the program. And with respect to (i), I think it is important to note that Argentina's substantial financial needs arise in part owing to past slippages in fiscal policy. In this light, I wonder about the incentives we instill, and the signals we send, when we argue that large financial support (even if it is precautionary) is required to fill financing gaps arising under such circumstances.

Mr. Faini and Mr. Schlitzer submitted the following statement:

Argentine authorities should be commended for swiftly coming up with a comprehensive adjustment program that aims both at strengthening the macroeconomic outlook and addressing a number of crucial structural issues. We strongly support the request before us. We are encouraged by the new administration's willingness to forcefully address Argentina's economic situation and by the ambitious program they are committed to implement. The Fund program can be critical in sustaining market confidence in the economy and in the adjustment effort. The latter requires, among other things, a series of essential measures that stretch over a few years, hence we also find a longer-than-usual arrangement (3 years) fully appropriate. It can obviously be discussed whether an SBA was the right instrument to this aim–a topic for our review of Fund financial policies–but a strong medium term program, with a substantial structural component, is exactly what is needed for Argentina.

Fiscal consolidation remains centerpiece to the program and it could not be otherwise. This should help reverse the deterioration in the public accounts while at the same time contain the external current account deficit. We note that the fiscal package, which has recently been approved by Congress, envisages a reduction of the federal deficit by 2 percent of GDP over the program period, and eventually the deficit should disappear in 2003. We are indeed impressed by the tough measures recently taken by the executive branch to reduce expenditure, which are well described in Mr. Zoccali's statement. The real GDP growth forecast for 2000, be it 3.5 percent as indicated by the staff or 4 percent as indicated by the authorities, suggests that the contractionary effect of fiscal consolidation will be largely offset by the improvement in the overall external environment. It should be clear, though, that such an improvement is predicated on a timely implementation of the overall program, including the structural measures. Failure to execute important parts of the program could well deprive Argentina of the "confidence effect" and leave it only with the contractionary effect of fiscal policy.

The proposed fiscal framework appears particularly bold in limiting indebtedness by the provinces, a major cause of past slippages. The "federal commitment" should lock in for the federal government most of the gains from the tax package and lead to "provincial fiscal responsibility laws," which have already been enacted by 8 of 24 provinces. We fully support the choice to include among the quantitative targets an indicative limit on the combined deficits of the federal and provincial governments. Looking to the medium term, however, it is necessary to redefine the revenue transfer system between the federal government and the provinces and limit the latter's ability to borrow. We understand this is indeed the authorities' intention.

A few comments on structural policy. The list of proposed measures is indeed quite comprehensive and we must commend the authorities for some key measures that they have already submitted to Congress, in particular in the area of tax administration and the labor market. The latter is crucial to increase the economy's productive efficiency and ability to absorb external shocks in the context of the CBA.

Greater labor market flexibility is also essential to boost employment and reduce unemployment from its very high levels. In this regard, however, we note that the rise in unemployment since 1999 reflects to a large extent the increase in the labor force more than a fall in employment. We would like to hear staff views on this issue. Does the relative stability in employment reflect large severance costs? Can the increase in labor force participation be interpreted as a healthy development or does it reflect the deterioration in the economic conditions of poor households? Overall, we support the proposed labor market reforms and hope that they will not find obstacles in Congress.

On the Banco Nación, we agree with the staff that transforming it into a corporation would make its operations more transparent. We are somewhat concerned by the possibility that the Banco could be used as a vehicle to give priority in the allocation of credit to small and medium enterprises. We wonder whether the authorities have other, more effective, tools to achieve this objective. We would also like to know from the staff or Mr. Zoccali what the medium-term plans for this bank are.

We regret that the previous EFF with Argentina went off track. Mr. Zoccali in his informative statement has reminded us of the series of factors that have adversely affected Argentina's performance. Indeed, the contraction of GDP in 1999 (3 percent) was twice what the staff had projected on the occasion of the 3rd review of the EFF, less than a year ago. Yet, one cannot neglect the role that serious slippages, in part related to the electoral cycle, have played in this. More crucially, and with the benefit of hindsight, Argentina should have pursued a stronger fiscal consolidation effort since 1994, taking advantage of its high growth rates to build a cushion against more adverse circumstances. Between 1995 and 1998, the primary balance improved by less than one percent of GDP with the overall balance remaining virtually unchanged. Had a strategy of early consolidation been pursued with sufficient vigor, Argentina would not face today the delicate trade-off between the need for macroeconomic consolidation and the need to support the still fragile recovery.

On external sector issues, we agree with staff that the present exchange rate regime has served the economy well. Renewed growth in both exports and output is however essential to reduce existing vulnerabilities, which have worsened during the last few years. As well described by staff a nominal depreciation of the exchange rate would not be a panacea, but quite to the contrary would pose very substantial risks. On trade policy, we would urge Argentine authorities to resolve existing regional disputes and pursue a liberalization agenda that looks beyond the purely regional borders. Argentina indeed was hit hard by the recession in the region. With a more diversified geographical allocation of exports, the effects of the regional recession would have been substantially milder. Remarkably, in the first half of 1999, exports to the Mercosur suffered a fairly dramatic fall, 27.6 percent, while exports to the EU increased by 10.3 percent during the same period. Perhaps surprisingly, exports to NAFTA did not show any noticeable change. Staff comments would be appreciated.

Finally, in considering the present request for an SBA we must say that we would have preferred that the structural measures that were required, but failed, under the EFF be set as prior actions for the current arrangement. We are referring to the (failed) measures described in paragraph 9 of the report: proposals to transform the Banco Nación into a public corporation, changes to the tax code, additional reforms to the social security system, and modifications to the central bank charter and banking law. But we are reassured that these measures are now part of the extensive list of structural benchmarks.

We wish the authorities success in their future endeavors.

Extending his remarks, Mr. Faini said that the effort by the Argentine government to enhance the financial sector had paid off well in strengthening the resilience of that sector in the most recent crisis.

Mr. Pickford and Mr. Burgess submitted the following statement:

This program has many features which one would expect to see in a Fund Contingent Credit Line (CCL):

Argentina is, arguably, implementing policies which are unlikely to give rise to a need for Fund resources. The need for this program is justified on the grounds that Argentina has substantial recurring external financing needs which it ordinarily meets (and expects to continue meeting) through the private capital markets. Access to substantial Fund financing would be useful on a precautionary, or contingent, basis—specifically in the event of a temporary interruption in normal access to the private capital markets following a sudden and disruptive loss of market confidence; staff rightly argue that existence of a Fund arrangement will, in itself, inspire confidence that Argentina can meet its external financing needs and therefore reduce the likelihood of any interruption in access to the capital markets.

Argentina's economic record has been assessed favorably by the Fund. Transparency in economic policy making is generally high and Argentina has subscribed to the SDDS.

Argentina maintains constructive relations with its private creditors. Contingent credit lines with private banks are in place, and the authorities recently undertook an international roadshow to explain their external financing policies.

A substantial amount of money would be made available on approval of the program.

However, there are currently some fundamental weaknesses in the Argentine economy which, on balance, make an SBA an appropriate choice. These fundamental weaknesses are related to structural deficiencies in the public finances and to question marks over the competitiveness and flexibility of the economy. In the face of large and persistent external financing requirements, these weaknesses could trigger a "rollover" crisis.

The authorities have indicated their intention to treat this arrangement as precautionary. Indeed they have already demonstrated on several occasions a commendable commitment to looking first to the private capital markets to meet their financing needs, even when the private capital markets have only been open to Argentina on relatively unfavorable terms. Nevertheless, the authorities will have immediate access to a substantial amount of money—around $1.3 billion—on approval of this program. Under a SBA there is no equivalent of the activation review required before money is made available under a CCL. This need not, of course, preclude the use of Stand-By facilities for precautionary purposes. But it does emphasize that the design of performance criteria, targets, and benchmarks is critical.

In this sense, we think the staff have done a good job in designing this program. The focus on fiscal and structural issues strikes us as appropriate given the weaknesses facing the economy. Staff also strike the right balance between formal performance criteria, indicative targets, and benchmarks, giving due weight to the excellent start which the authorities have made in building on the reform efforts of their predecessors. Looking ahead, we would be interested in staff views on whether Argentina is likely to be able to graduate to a CCL by the end of this program.

There is, however, one policy issue—debt management—which we think is central to the success of this program and which should have been reflected in a performance criterion. The principal motivation behind this Stand-By Arrangement is as precautionary funding to cover large amortization needs. Paragraph 20 of the Memorandum of Economic Policies refers to the intention to lengthen the maturity of debt and to smooth the profile. These are clearly desirable objectives which might have been made firmer through the inclusion of some quantitative targets.

Looking in a little more detail at some of the specific elements of the program, the challenge facing Argentina is clear. A long-standing burden of debt and persistent external imbalances have generated substantial and recurrent external financing requirements. Indeed, Argentina's external financing requirements are projected to remain roughly constant in nominal terms beyond the period covered by this program. Argentina's policy priorities should therefore be as follows:

To implement a credible program of fiscal consolidation. This would not only reduce the level of debt, but should also reduce the country risk premium associated with Argentina and therefore reduce debt financing costs. Lower interest rates will hopefully help to offset some of the negative impact of fiscal consolidation on economic activity.

To pursue structural reforms which will enhance the flexibility and competitiveness of the economy. These reforms are, of course, particularly important in the context of the Currency Board Arrangement.

The new government's policy agenda and this program have clearly been set with these priorities in mind. And we therefore welcome this. We also think that these reforms will do more to enhance confidence in the economy and reduce country risk than would dollarization itself. We therefore agree with the authorities' view that dollarization is an issue for the longer term rather than the immediate future.

The proposed pace of fiscal consolidation looks appropriate given the need to avoid withdrawing the fiscal stimulus too abruptly while recovery remains relatively weak. We agree with staff that it is prudent to base a program on conservative assumptions for economic growth, although we are not convinced that a growth rate of 3.5 per cent for this year is particularly conservative. Nevertheless, if recovery proves rather firmer than expected, any overperformance against the fiscal targets should be used to increase the pace of consolidation rather than to finance additional spending plans or tax reductions. We also welcome the Fiscal Responsibility Law which we think will serve Argentina well over the longer term.

Provincial finances are central to any comprehensive solution to Argentina's fiscal problems. In this respect, this program represents a significant improvement on its predecessor in terms of the increased emphasis on the provincial finances, and in particular the inclusion of binding ceilings on the level of consolidated public sector debt from the end of this year onwards. We would be interested to know whether this ceiling will in itself improve fiscal discipline among the provinces. It could, arguably, lead to pressure for spending cuts at the federal level to offset any weakness in the provincial finances. Such cuts would be difficult given that the federal government accounts for significantly smaller share of discretionary spending than the provinces.

The authorities have already made a positive start with the negotiation of debt refinancing agreements (in exchange for lower provincial deficits) with a number of provinces, although not yet with Buenos Aires which in recent years has accounted for a substantial and growing proportion of the provincial fiscal deficit.

Any sustained improvement to the public finances will depend on reform of the federal-provincial co-participation system. The current system has a number of significant drawbacks:

It does little to enhance fiscal discipline within the provinces.

It has undermined the government's ability to run a counter-cyclical policy. This is particularly damaging in Argentina's case given the impotence of monetary policy in cushioning cyclical swings.

It is extremely complicated. This lack of transparency can in itself damage confidence in the government's macroeconomic management.

The reforms outlined in paragraph 18 of the Memorandum of Economic Policies would go some way to addressing these drawbacks. They will inevitably be the subject of a protracted debate within Congress. It is nevertheless important that all the key elements of these reforms be preserved.

In parallel with these efforts, the authorities must of course also seek to improve discipline at the federal level. Indeed the shortfall in government finances last year had more to do with poor revenues than with any deterioration in the provincial finances. In this respect, we welcome recent tax reforms and in particular the comprehensive set of measures which have been announced to improve compliance.

We also welcome the government's commitment to implement reforms to ensure the long-term viability of the social security system. The pension reforms look sensible: better targeting of public pension provision towards low income groups while encouraging private provision for higher earners is much the same as the approach being adopted in the UK.

It would be useful if staff could, in future reviews, provide more detailed analysis of the long term implications of these reforms for the public finances. We also wondered whether any thought had been given to any further parallel reforms of the tax system which would encourage more workers back into formal employment, and could also have a positive impact on the public finances.

This chair has on many occasions stressed the need for increased labor market flexibility in Argentina, not least to enhance the economy's ability to respond to adverse shocks in the context of a Currency Board Arrangement. So we greatly welcome the labor legislation reform bill and hope that it will be passed by Congress largely intact. This should, however mark the beginning rather than the end of the process of freeing up Argentina's rigid labor laws.

The strength of the financial sector is one of the central pillars on which the Argentine economy is based. Like staff, we think the financial sector is in very good shape. This reflects the comprehensive strengthening of the financial regulatory framework in recent years. The participation of foreign financial institutions is also an important reason behind this success. It is reassuring to note that further improvements to this framework are being considered.

The staff has noted, however, that there has been little growth in credit to the private sector over the past year. This could partly represent a temporary side effect of recent strengthening of financial supervision. It probably also represents some crowding out by the government. According to table 7, there was a substantial increase in net credit to the public sector last year. Like staff, we believe the authorities should avoid using government-owned institutions to encourage the allocation of credit to support specific sectors of the economy. We are also reassured by Mr. Zoccali's statement which notes that the authorities will not seek to influence the market-based process of credit allocation. We would be interested to know whether staff agree that shift the focus of Banco Nación's loans towards SMEs and to farmers will reduce the risk attached to its loan portfolio. .

We would like to compliment staff for the quality of the program documentation which, in our opinion, was better than average. In particular, we appreciated the discussion of risks, the clear explanation of why this loan is necessary, the data on short term debt by residual maturity, and the sectoral estimates of net foreign currency liabilities.

We these remarks, we support Argentina's request for a Stand-By Arrangement.

Ms. Portugal and Mr. Mori submitted the following statement:

We welcome this new three-year Stand-By Arrangement for Argentina and support the proposed decision. The program is strong and will provide an appropriate policy framework and the necessary financing safeguard to allow a rapid and sustainable economic recovery. The arrangement is seen as precautionary, as Argentina continues to have access to the international capital markets thanks to its strong track record of policy implementation and reforms. Certainly, the arrangement will provide the necessary support for Argentina to overcome the still uncertain prospects that lie ahead in international capital markets and help the economy to reach faster a steady growth path.

Under the convertibility plan, Argentina has shown remarkable macroeconomic discipline and, as a consequence, has been able to enjoy a generally strong economic performance. However, like other economies, the country has experienced a combination of severe external shocks as noted by the staff. The contraction in real GDP was very steep, declining by 3 percent in 1999 as compared to a high positive growth rate of 8.1 percent in 1997. We are pleased to note that there are clear indications of recovery, with industrial production and construction activity growing at a sustained pace. Indeed, in view of the improvement in the external environment with economic recovery in the region as a whole, stronger growth in Europe and the progress already made in the implementation of fiscal and structural measures, we share the authorities' views regarding the real GDP growth prospects.

The immediate task is to correct the fiscal imbalances observed in 1999. These were partially because of the economic slump and its ensuing shortfall in revenues and, as Mr. Zoccali pointed out in his statement, had a neutral impact. The authorities should be commended for their quick and decisive move to submit and get approval by Congress of a series of important measures. They showed determination and political clout in carrying further the necessary policy actions and the reform agenda. The budget, the fiscal package, and the agreement with the provinces are all already approved.

The staff estimates the contractionary impulse of fiscal retrenchment on domestic demand at around 1.7 percent of GDP in 2000 (paragraph 19), which is considerable in the current stage of the business cycle. One can expect that improvements in the market sentiment with the implementation of the program, lower financing costs for private sector borrowers, and a better perspective in the external environment may benefit the economy. But there is a need to monitor closely the economic developments to avoid fiscal tightness from exerting an undue burden on the recovery. In this respect, the program contemplates a consolidation process with front-loaded deficit targets, taking into consideration (i) the fact that the economy is in its initial stage of the recovery process, (ii) the lag of new revenue measures in generating resources and (iii) a change in the seasonal pattern of transfers to provinces. Given these considerations, we believe that the program provides a reasonable phase-in of fiscal targets and contemplates a good balance between fiscal consolidation efforts and a sustainable economic recovery process.

The fiscal consolidation and reform program, whose main elements are outlined in paragraph 17 of the report, is well designed. We are pleased to note that the authorities are taking further steps in the complex process of integrating the provinces into the federal government's fiscal consolidation. We support the efforts to strengthen tax enforcement and reduce evasion. In addition, despite having already implemented a comprehensive social security reform, the authorities are taking further steps in this area with a number of new initiatives. This is an additional and important indication of the commitment of the authorities to a strong policy framework.

We welcome the approval of the Fiscal Responsibility Law, which will provide the government with a disciplinary instrument to ensure the viability of the public finances in the long term. The Law seeks the elimination of the overall deficit of the federal government and incorporates a counter-cyclical fund that will allow certain flexibility for budget management to smooth the fiscal path over the cycle. Mr. Zoccali points out that the fiscal targets of the program are already fully in line with the Law. We see with interest the adoption by provinces of a law similar to the federal one, which reinforces their commitment to the consolidation process.

The staff is concerned with the adverse medium-term impact on tax compliance of the authorities recourse to tax moratorium. We agree that granting a tax moratorium, although increasing revenues in the short term, might have adverse effects on future tax compliance. The authorities themselves also recognize this point. However, this type of conflict between short- and medium-term objectives involves a difficult judgment call that the authorities are, perhaps, in a better position to make. In this respect, it is important also to notice that the authorities have taken important steps to substantially strengthen tax compliance, which would help minimize the potential adverse effects on tax compliance arising from the moratorium.

Despite the severity of real and financial shocks, and the resulting contraction in economic activities, the banking system withstood well the recent international turmoil and has maintained generally sound conditions. We should recognize the merit of the authorities' continued efforts to strengthen the financial system. The positive outcome has been the public confidence in the system with continued growth in bank deposits even in a turbulent period. We agree that, in a Currency Board Arrangement, the liquidity requirement and the contingent repo facility with foreign banks remain important elements of the prudential framework, helping to ensure the stability of the financial system.

The improvement in the current account from US$14.4 billion in 1998 to US$12.3 billion in 1999 reflects largely a sharp fall in imports as a consequence of recession. Exports also contracted in value terms in view of the deterioration in terms of trade, the weakening of demand in Argentina's export markets in the region, and the contraction in trade financing, making the external adjustment more severe. Nonetheless, as Mr. Zoccali noted, export growth at the beginning of this year is encouraging. We also note the favorable composition of external financing as more than half of the external current account deficit was financed by net foreign direct investments, and a significant part of private sector financing was obtained through intercompany loans. Moreover, prudent external debt management with a policy of borrowing in advance of actual needs has allowed the authorities to overcome with sufficient margin of maneuver the periods of turbulence in the global financial markets.

The convertibility regime has been--and continues to be--a key element in the macroeconomic framework that has produced the remarkable outcome in the 1990s with high growth rates and a negligible inflation. This regime has been fully embraced by the Argentine population and governments across the political spectrum not because of expediency reasons, as Mr. Zoccali pointed out, but as a permanent framework that fosters fiscal discipline and productivity improvement. We fully support the authorities' and the staff's views that this regime serves Argentina well.

In this respect, it is essential that the still unfinished agenda of further structural reforms and fiscal consolidation continues to be pursued so as to increase the consistency of the overall policy framework. The authorities have taken important steps to reform labor legislation, to reduce labor costs and increase productivity, and to promote domestic competition, all of which are key to improve competitiveness.

Finally, we agree with the proposed amount for the first drawing, which we find commensurate with the strength of the program and with the objective of restoring the accumulated undrawn amounts foregone in the previous precautionary arrangement.

Mr. Tornqvist and Mr. Sigurgeirsson submitted the following statement:

We welcome the proposed new program for Argentina, which will offer the country the opportunity of a fresh start. This is needed not least in view of the deterioration in public sector finances, which went substantially off track, notwithstanding that they had been revised under the Third Review under the Extended Arrangement in May 1999. The revision was accepted in view of adverse external developments. However, it appears that the program went off track after the recession bottomed out in the latter part of the year. It is also regrettable that the authorities fell short of meeting structural benchmarks.

We believe that the new set of policy measures that the Government has swiftly adopted and committed itself to implement will be crucial for restoring macroeconomic stability and confidence. While we are in broad agreement with the staff proposal, we have a few comments on public sector finances, the external debt, the current account deficit and the financial sector.

The outlook for the Argentine economy is currently favorable in light of the anticipated improvement in the external environment. While average annual growth rates of 4 percent are not unusual in emerging economies, there is clearly reason for caution, as important fiscal performance criteria are built on relatively rapid GDP growth. The amount of the Stand-By is, by any measure, very high, and full utilization can raise the use of Fund resources close to the allowable limit. With this much at stake, it is vital that the program stays on target.

We welcome the effort of improving the structural fiscal balance. In this respect, we find it encouraging that fiscal federalism issues are explicitly addressed in the program. We hope that the state governments will be able to follow up on budget improvements.

Although it is still early, certain signs indicate that the economy might not be picking up as fast as expected. As the success of the program hinges of fiscal vigilance, the authorities should be prepared to implement additional policy measures to meet the fiscal performance criteria if evidence of slower than envisaged rates of growth would materialize.

Moreover, since the objective of reducing the deficit from 3.9 percent of GDP in 1999 to a balanced budget in 2003 is quite ambitious, it is clear that deviations from the indicative targets in later years need to be corrected for, as the deficit target is only binding for the year 2000.

We see the external indebtedness as one of the major risks to economic development. The heavy burden of the public debt will be a major obstacle for the Argentine economy to move towards a path of sustainable long-term growth. There is some information on the external debt situation in the staff report, however, more precise information on the structure of the debt, not least for the private sector, would have been welcome.

Even if the public sector debt appears to be managed in a responsible manner, with pre-funding and long maturities, the cost of the debt may well prove to be burdensome in the long run. This could prove even more challenging in light of the potential impact of increasing interest rates. Therefore, we urge the authorities to focus on the matter of reducing external debt. The benefits of external debt reduction could be substantial in the case of Argentina, as they would entail not only savings on current debt service, but also in reduced interest rate spreads with respect to new issues.

The private sector debt is also quite sizable. According to the figures in the staff report, the size of the funding requirement for this year is not far from that of the public sector. According to market sources, private sector amortizations are quite concentrated in the second quarter. This could emerge as a problem area. If funding problems appear and begin to rattle investors, it could possibly become a source of instability.

The current account deficit is another matter of concern. We see risks that improved external trade performance will not materialize as envisaged in the program, and also in the potential effect of the global trend of increasing interest rates. Moreover, faster economic growth could lead to an increase of the current account from the demand side. We urge the authorities to pay close attention to developments in this area, as the external debt burden is already very high.

It might be worthwhile to attempt to further stimulate private savings in Argentina in order to reduce the dependency on foreign capital. The economic program would benefit from structural reforms aimed at increasing private savings.

It is gratifying to note that the banking system emerged relatively unscathed from the crisis. However, we can see that the abundant liquidity in the banking sector can prove to be a double-edged sword. On the one hand, it bolsters the stability of the banking sector. On the other hand, the excess liquidity increases the potential for capital outflows, posing a risk for the currency board and contributing to higher interest rates. The situation calls for close surveillance by the authorities.

Finally, we note that the proposed SBA would replace an EFF that has never been drawn on. It would be interesting to get comments from the staff on the reason for changing the type of facility. Furthermore, Argentina was not long ago perceived as the most obvious candidate for a CCL. In my view, the fact that this kind of facility is not being proposed now says something about its usefulness. But maybe this issue is better discussed in another context.

With these remarks we support the proposed decision.

Mr. Kelkar and Mr. Keshava submitted the following statement:

At the outset we would like to commend the authorities for formulating a strong economic program to be supported by a new three-year Stand-By Arrangement. Due to adverse external shocks, the Argentina's economic performance deteriorated significantly since mid-1998 which also affected the performance in 1999 under the arrangement with the Fund. However, the Argentine economy has benefited considerably from the efforts made in the last few years to create a strong and resilient financial system which has helped it in withstanding the recent turmoil. It is encouraging to note that there are signs of improved market confidence which are reflected in the favorable response to recent sovereign bond issues. We are happy to note from the excellent staff paper and comprehensive statement of Mr. Zoccali that the new administration is firmly committed to maintaining a firm macroeconomic stance and accelerating structural reforms to further enhance efficiency and resiliency of the economy and secure strong and more equitable growth in Argentina. Though the staff paper recognizes the risk relating to external environment as well as domestic political vulnerabilities, the authorities have demonstrated strong ownership of the program and commitment to implement it fully. Our chair welcomes the request of the authorities for a Stand-By Arrangement and supports the proposed decision. As we are in broad agreement with the staff appraisal, we will make a few remarks for emphasis.

Fiscal restraint is one of the crucial elements of the new Argentine policy framework. The program envisages a significant reduction in the consolidated public sector deficit over the three-year period. The achievement of substantial primary surpluses under the program will limit the growth of public debt as a percent of GDP. With the passage of the Fiscal Responsibility Law, a positive signal has gone to the market about the commitment of the authorities towards fiscal discipline. However, the risks on growth prospects emanating from the ambitious front-loaded adjustment envisaged in the current year need to be closely monitored as the economy is emerging from recession. We welcome the progress made in strengthening tax administration, taking steps for significantly expanding the bases of the income and value-added taxes, increasing the personal and wealth taxes, and reducing the scope for tax avoidance and evasion. The program conditionality through a binding ceiling on the consolidated public sector debt at end-2000 to also account for the finances of the provinces will impart credibility to the fiscal adjustment efforts. We welcome the transitional Federal Accord with the provinces and hope that the authorities will soon reach an agreement on a more permanent reform of the revenue sharing system. This will also strengthen the fiscal responsibilities of the provincial governments.

We concur with the staff assessment that the Currency Board Arrangement has served the country well and it would not be advisable to devalue the exchange rate. Admittedly, the advantages of the convertibility framework are numerous as detailed in the staff paper and the statement of Mr. Zoccali that would rule out any change in the exchange rate regime as a policy option. During the last Board discussion, proposal to move forward from a currency board regime to full dollarization of Argentine economy was debated. With the decision of the authorities to continue with the current arrangement in the foreseeable future, the uncertainty associated with the possible change in the currency regime is over.

The external current account deficit, which increased substantially in 1997, will remain high during the program period. The total external debt service as percent of exports of goods and non-factor services is expected to reach a very high level of 96 percent in 2001. The projected requirements and sources of foreign exchange presented in Table 10 of the staff report indicate substantial debt creating inflows in the medium term which remain an area of concern.

In the earlier discussions on Argentina, the staff indicated disappointment with the limited progress achieved in the area of labor market reform. However, our chair always supported the effort of the authorities to build a consensus on sensitive labor issues as this will ensure the reforms to remain sustainable in the long run. We are happy to note that the new administration has presented a comprehensive labor reform bill after broad consultation which is expected to be gain approval shortly.

In conclusion, we support the proposed decision and wish the authorities success in their future policy endeavors.

Mr. Mirakhor submitted the following statement:

The speed and decisiveness with which Argentina's new government has addressed the economy's difficulties is impressive. In just a few weeks, congressional approval of a strong budget and a fiscal package was obtained, a transitional agreement on revenue-sharing concluded with the provinces, and a number of structural reform proposals articulated to address key areas of weakness in the economy. In sum, these elements form the basis for the authorities' request for a new three-year Stand-By Arrangement with the Fund. Given the comprehensive and well-balanced nature of the adjustment and reform effort, its full ownership, and the authorities' strong commitment to rapid and sustained implementation, we have no hesitation in supporting the proposed arrangement and the level of access.

As Mr. Zoccali's lucid statement suggests, the authorities clearly recognize that adjustment must be anchored in strong and sustained fiscal measures so as to boost public savings and bring down net public debt in relation to GDP to more sustainable levels. Reflecting this focus, and the strictures contained in the Fiscal Responsibility Law, the fiscal program is appropriately ambitious—especially when viewed in terms of the primary public sector balance—and includes both a significant revenue effort and tight limits on expenditures. We welcome the generally high quality of the proposed measures, underscore the importance of adhering fully to the commitment to control spending, and attach high importance to effective and sustained efforts to broaden the tax base and strengthen compliance. Fiscal adjustment will also be facilitated by the transitional Federal Accord with provinces that seek to ensure that higher tax revenues will serve to consolidate the federal accounts, rather than augment provincial transfers.

The staff note that provincial finances pose some risk to the program. We encourage the authorities to use all available instruments of control to achieve an improvement in this area. The World Bank and the IDB also have an important role to play in this process. We are especially pleased by the agreement in principle with the provinces that each of them will introduce a fiscal responsibility law on the same pattern as for the federal government. As Mr. Zoccali notes, the key task looking ahead is for the federal and provincial governments to reach agreement on a permanent reform of the revenue sharing system. We hope that the Federal Council will help facilitate the needed political consensus on the complex issues involved.

Notwithstanding recent market concerns about sustainability of the exchange rate regime, we support the authorities' decision to rule out a devaluation of the exchange rate, given the foreseeable adverse impact on the economy. Confidence in the exchange rate regime and the needed improvement in the external accounts could be fostered by resolute implementation of the government's macroeconomic policies and structural reforms that strengthen external competitiveness. In the latter context, we welcome the initiatives taken by the authorities to reform the labor market—which should contribute to wage moderation—and generally strengthen competitive forces in those sectors of the economy which have hitherto enjoyed quasi-monopoly status.

Argentina's impressive resilience to external shocks emanate mainly from the fundamental strength and soundness of the banking sector. We support the planned reforms in the financial sector and are reassured by Mr. Zoccali's statement that the measures being taken to limit loan concentration aim at achieving risk diversification and that the authorities have no intention of influencing the market-based process of credit allocation.

The Deputy Director of the Western Hemisphere Department said that the staff had received an official request from the authorities to cancel the Extended Arrangement upon approval by the Board of the SBA.

The Secretary said that a revised decision had been issued that morning that included the cancellation of the Extended Arrangement.

Ms. Lissakers made the following statement:

We commend the authorities for working quickly and effectively with the Fund to develop this program following the completion of last year's election cycle. The resulting program demonstrates their clear commitment to fiscal responsibility and structural reforms, and we are pleased to offer our support for these efforts.

The authorities' decision to make a clear public statement of their intent to treat this program as precautionary is the right one. This sends a strong positive signal to markets about the confidence that they and the Fund have in this program.

Going forward, it will be important to show consistency between commitments made and actions taken. I note that performance slipped, particularly in the second half of 1999, contributing significantly to Argentina's worsening debt situation.

Argentina's economic performance under the Currency Board Arrangement is paradoxical. The arrangement has helped stabilize prices and policy making, serving as an anchor not only for monetary and exchange rate policy, but also for broader reforms. Growth has been high but volatile as external debt has increased sharply. Argentina remains trapped by the high income elasticity of imports and a weak export sector. Poverty has increased, as indicated in the staff report, and unemployment and underemployment has come down since 1995 but remain high.

The program negotiated with the Fund is designed to enhance the positive features of Argentina's recent economic performance while addressing the serious shortcomings.

The strengthening of policy performance is urgently needed. The sensitivity analysis in Figure 4 of the staff paper illustrates starkly why there is no room for slippage in the near term. Even the baseline scenario has debt servicing rising to very high levels relative to exports in the near term before declining over the medium term. Policy slippages and/or adverse developments such as higher dollar interest rates could pose an even more daunting challenge to the external balances.

The authorities' goals of deficit reduction as laid out in the program will be essential to put public debt on a declining path as a share of GDP and to reduce rollover risk going forward.

Given Argentina's dependence on international capital markets and constraints on rapid adjustment in external accounts, a prudent fiscal stance is an imperative. We are thus pleased with early action taken so far by the authorities to strengthen the fiscal stance. Securing parliamentary approval of an ambitious fiscal package was a major achievement. The 2000 revenue sharing arrangement with the provinces is another important step toward introducing greater discipline in provincial government finances.

While achieving 2000 targets under the program relies on what are essentially one-off measures, we are encouraged by the authorities' detailed plans for working toward a more permanent solution. It is critical for Argentina's fiscal sustainability going forward that the upcoming negotiations with the provinces have the desired outcome, thus we urge the authorities to act quickly to institutionalize a more supportive fiscal-federal arrangement.

In this regard, we note the federal program for refinancing provincial debt, which provides a strong incentive for the provinces to meet their fiscal and debt targets. This is an innovative way to work around constitutional constraints on the federal government's influence over provincial fiscal behavior.

We are also encouraged by the authorities' early action on structural reform. The package of structural reforms already sent to Congress aims at improving Argentina's competitiveness, and includes reform of the public and social security administration, measures to fight tax evasion, changes in labor laws, and measures against corruption. Comments from staff or Mr. Zoccali would be welcome on prospects and timing for passage of the entire package.

Passage of the labor reform bill in the House is a particularly promising development. Some particularly noteworthy features of this bill include provisions for phasing out ultractividad, thereby restoring the bargaining incentive of unions and employers, and for decentralizing collective bargaining, which is already taking place to a large extent in the country. The authorities' decision to move quickly and aggressively on this issue shows they understand the importance of pursuing policies that enhance workers' productivity and strengthen Argentina's competitiveness overall.

This reform is particularly controversial given Argentina's weak job growth performance to date and high unemployment. Controversy is unlikely to subside unless job growth accelerates sharply.

The proposed reforms to the labor code, which the Fund has included as a structural benchmark, may have significant effects on the structure and conduct of collective bargaining and the future of labor-management relations. The proposed law appears to be consistent with ILO's interpretation of Convention 98 on collective bargaining (ratified by Argentina) insofar as it permits collective bargaining to occur at various levels, though this is not entirely clear. Can Fund staff provide clarification?

Argentina's Currency Board Arrangement has contributed to an impressive performance on stability over the past decade, and high, if volatile, growth. For Argentina to realize fully the potential benefits of the Currency Board Arrangement going forward, it will be important to pursue vigorously its program of fiscal consolidation and structural reform.

It seems that the program's NDA ceiling prevents Argentina from substituting domestic sovereign debt for foreign reserves as backing for base money, even though the Convertibility Law allows the central bank to back as much as one-third of the monetary base with dollar-denominated Argentine Government debt. Thus, the program constrains Argentina to act like a "true" currency board. Is that the correct interpretation?

Mr. Faini noted that, in response to Ms. Lissakers's question about whether the new labor law complied with the International Labor Organization (ILO) convention, the compliance with such conventions was voluntary. The staff could provide the Board with a list of all of the countries that had adhered to that convention.

Mr. Milleron made the following statement:

> Argentina, today, seems quite another country than it was three or four months ago, when the ability of the currency board to survive the recession and Y2K problems was being overtly challenged even in this room, and Mr. Mussa advocated prayer as the most efficient policy to get the country out of the dire straits it was in. Now, Argentina has a new government, whose strong views and determination have succeeded in creating an unprecedented momentum for reform and adjustment. Beyond good intentions, more has already been done in the last few months than in years before, and the markets are responding enthusiastically: since the beginning of the year, Argentina's spread has dropped by 200 points, the stock market is up by 15 percent and bank deposits are back on an upward trend, with peso-denominated deposits outpacing dollar-denominated ones. Finally, to top it all, the authorities have committed themselves, through their latest letter of intent, to a very comprehensive and bold adjustment and reform program, which addresses in a very sensible way all the critical issues to put Argentina back on a sustainable growth path
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> This combination of factors obviously creates a window of opportunity in which failing to provide Fund support would probably be an error. Nevertheless, this acknowledgement leaves open the questions of how much support we should provide and how we should provide it.
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> First, let's tackle the amount issue. I was disappointed to see that, in spite of the clear request presented by this Board only weeks ago, the proposed amount is all but forcefully justified. 7.4 billion dollars over three years is a large amount of money; yet it is unlikely to be sufficient to cover Argentina's needs in case of a currency crisis. So, it would have been useful if Staff had explained how they arrived at that figure. The fact that the authorities intend to treat this arrangement as precautionary does not in any way suppress the need for justification, as once we approve the loan they will be entitled to draw on the released tranches without further notice.
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> In this connection, an additional issue is the massive frontloading of the program. Indeed, I fear we might find it hard to explain to other borrowers that we agreed to unlock 1.3 billion dollars without any prior actions and regardless of the fact that most of the targets of the December 1999 program review were missed (to be accurate, Argentina reached only 2 performance criteria out of 6 and 3 structural benchmarks out of 10). Staff argues that this

frontloading aims at compensating for the accumulated rights which would be foregone with the abandonment of the current program. But, I am afraid the rights accumulated under that EFF are simply non existent, because the program is off-track. Furthermore, it could be argued that getting a program which spans 2 years beyond the current EFF and gives access to almost three times as many resources is a good enough compensation in itself.

Second, I have some reservations as to the precautionary nature of the requested arrangement, as it goes along with heavy borrowing for multilateral development banks. The Argentine authorities have been playing this strategy for the last two to three years, and it results in an unfair and, most importantly, inadequate, burden-sharing between the IMF and MDBs, which we should not encourage.

Third, I really feel that the choice of a Stand-By Arrangement, as opposed to other available instruments, warranted some discussion, if only to have a clear case in point when we discuss the Review of Fund Facilities. Indeed, to help a country tackle balance of payments difficulties which are largely structural and thus require a medium-term program to be sensibly addressed, the SBA is certainly not the first instrument that comes to mind. The EFF is. At the same time, I tend to think the EFF should be primarily targeted at developing or transition countries which have actual problems tapping into private financial markets. These criteria will, of course, have to be clarified by our forthcoming discussion on Fund facilities, but, at first glance, they would seem to rule out Argentina.

On the other hand, if the authorities -- apparently supported by Staff -- are so convinced that they can fulfill their balance of payment needs without having to actually use Fund resources, barring unforeseen perturbations on financial markets, arousing for reasons beyond their control, then maybe they could apply for a CCL, which was especially designed for this kind of situations, i.e., "to provide members with strong economic policies a precautionary line of defense which would be readily available against balance of payments problems that might arise from international financial contagion" (quoted from the Staff's Preliminary Considerations on the Review of Fund Facilities, page 17). So, I would find it most interesting to hear from Staff if they feel that Argentina meets the four criteria spelled out in the same paper, namely (i) an absence of need for use of fund resources from the outset ; (ii) a positive assessment of policies by the Fund, which seems abundantly documented in the Staff report ; (iii) constructive relations with private creditors, which is also well illustrated by the Staff report; and (iv) a satisfactory economic and financial program, a label which the program presented in the letter of intent attached to the present request undoubtedly deserves.

These issues having been raised, I am convinced that the Fund is at a crucial juncture. We can go along with the proposed decision.

Mr. Palei made the following statement:

For Argentina's economy, last year turned out to be more difficult than the authorities and the Fund had hoped for. Cornered by unfavorable external conditions and pressured by elections-related demands, the authorities were unable to meet the fiscal targets on deficit and non-interest expenditures specified in their EFF program. The staff argue that unsatisfactory performance under the EFF program could be attributed primarily to the difficulties of reaching, in the run-up to presidential elections, the necessary social and political consensus on the pace of structural changes in the economy of Argentina.

The proposed stand-by program in its fiscal objectives is essentially aimed at delivery on the promises already made by the authorities under the EFF. For the year 2000, the two-percentage point fiscal adjustment would bring the overall fiscal deficit to Arg$6.9 billion, i.e. to the level the authorities aimed at last year. Clearly, for Argentina, the risks associated with deviations from fiscal targets are large, and, therefore, the authorities' desire to be conservative is understandable. Furthermore, caution should be exercised not to endanger the still fragile economic recovery in Argentina. However, I still feel that, for the second and third years of the program, when the results of the currently undertaken reforms have to bear fruit, the goals of the program could be more ambitious. In this respect, the staff could comment on the authorities' contingency plans for the use of resources from possible overperformance in the fiscal area and if there is any agreement between the authorities and the staff on this matter.

I note the decisive actions undertaken by the authorities to regain control on the fiscal situation in the country. The government came up with selective expenditure cuts, introduced measures aimed at raising additional revenue equivalent to about 1.2 percent of GDP, agreed with provinces on federal commitment and have already signed individual fiscal agreements with seven provinces. Hence, there is an evidence of a good start that builds upon the Fiscal Responsibility Act and other measures introduced by the previous administration. As for the medium term fiscal framework, I believe that the authorities' attention to the issues of tax evasion and their emphasis on tax administration are fully justified. Similarly, implementation of measures aimed at the efficiency of primary expenditures and proactive approach to fiscal health at the lower levels of the government are indispensable for fiscal consolidation. As for the latter, the transitional agreements on revenue sharing with provinces, in my view, should not be considered a detriment to a more permanent rules. The experience gained from the use of individual agreements with provinces could be helpful in designing a more permanent mechanism to be introduced in 2002.

The authorities are firm in their commitment to the currency board system. Mr. Zoccali has reminded us that the main reason for their position is not the fear of transition to a flexible exchange rate regime, but a genuine conviction that the currency board is superior for Argentina's economic well-being. If the exit from currency board in favor of flexible exchange rate regime is outruled, more attention has to be paid not only to price flexibility, but also to adjustment through enhancement of competitiveness of Argentina. The issue of competitiveness goes to the core of sustainability of the current exchange rate regime in Argentina, since, in addition to effects on net exports, it feeds directly into balance of payments financing. Competitiveness defines future sustainable inflows of capital, including foreign direct investments.

Current pressures attracted attention, in addition to thoroughly studied labor market rigidities, to the deficiencies in competition policy, especially with respect to domestic prices of energy and the utilities sector. Maybe, the staff could comment on the recent vocal complains about the nature of competition in the pricing and distribution of gasoline, natural gas, and the utilities.

The reforms in financial sector can also significantly contribute to the improvements in Argentina's competitiveness. Among the emerging economies, Argentina is an accepted leader in reforming the banks. However, although the banking sector is very resilient to shocks, it is not very efficient, and there are still problems in the financial sector that hamper competitiveness of the Argentine businesses. One of the more visible ones is the high level of non-performing loans (NPLs). The high level of NPLs combined with high liquidity requirements explain very large spreads between the interbank and lending interest rates. Large spreads severely limit the efficiency of financial intermediation in the country. It would be useful to hear the staff's comments on why the level of NPLs is so persistent and what could be done to decrease the NPLs' share in the banks' assets.

Related to the above is an issue of loan market segmentation, in particular, that of access to credit for small businesses and exporters. I certainly welcome the authorities' desire to alleviate credit crunch for these sectors of the economy crucial for employment generation and for competitiveness. However, any programs in this area should be transparent and fiscally sound. Placing them into the federally owned Banco Nación is questionable. Although Mr. Zoccali in his statement argued that the concerns expressed by the staff are somewhat exaggerated, it is clear that the very possibility of doubts about the authorities' intentions warrant a careful review of the strategy toward small businesses and exporters. It also points to the need to deliver without delays on the promise to transform the Banco Nación into a state owned corporation. I would appreciate it if the staff could comment on the situation with another large state bank, Banco de la Provincia de Buenos Aires.

Coordination of economic policies with the main trading partners, especially the members of Mercosur, is another pillar of Argentina's strive for competitiveness. As I understand it, the Brazilian devaluation caused some tension in the relations between Mercosur countries. I am pleased to hear from Mr. Zoccali that the Argentine authorities are committed to regional cooperation and intend to pursue proactive approach in the trade area. Hopefully, other countries in the region will support their efforts.

To summarize, it seems to me that issues related to evaluation of Argentina's competitiveness, such as the financial sector efficiency, domestic competition and deregulation policies, fostering of small businesses and exporters, and coordination of policies with Mercosur members, and prospects for improvements in productivity in the medium term could feature more prominently in the staff report.

To conclude, Mr. Chairman, I endorse the proposed decision and wish the authorities success.

Mr. Carstens made the following statement:

The de la Rua government should be commended for the decisive actions they have undertaken in a very short period of time. Argentina has implemented strong stabilization and structural programs, which deserve support from the Fund by means of the 3-year stand-by agreement that the authorities requested.

Certainly the economy did not perform as desired during the 1998-1999 period. The Argentine economy was seriously affected by severe external shocks, among which the most important were:

Recession in major trading partners, intermittent access to capital markets during and after the Russian and Brazilian crisis, a sharp terms of trade deterioration, the devaluation of the real, and the strong performance of the US dollar versus other currencies. As a matter of fact, during the last five years, the Argentine economy experienced two recessions, one in 1995 and the other in 1998-1999, having in both cases external shocks as the main triggers.

This empirical evidence does not come out as a surprise since it is mostly the consequence of the exchange rate regime (ERR) choice that Argentina made. By having as nominal anchor a super-fixed exchange rate, Argentina sacrificed an adjustment devise that could have acted as a shock absorber. By this I do not want to imply that the ERR decision of Argentina was wrong or that it should be modified. On the contrary, the issue I want to emphasize is that given that the currency board is the ERR that should continue in Argentina, they should fortify it by pursuing aggressively other means of reducing the vulnerability of the economy to external shocks.

In general, under a currency board, authorities should focus in five areas to minimize the vulnerabilities of the economy to external shocks:

First, by strengthening the public finances; Second, by fortifying the financial system, including the non-bank sector; Third, by spreading out the maturity structure of both internal and external debt; Fourth, by enhancing the labor market flexibility; and lastly, by improving the competitiveness of the economy, through deregulation, structural reforms and investment both in physical and human capital.

It is encouraging to see that the program that is being presented to us today essentially concentrate in these areas. Particular attention is paid to fiscal aspects, and rightly so, since this has been the area where the poorest performance has been witnessed during the last years.

The fiscal commitments included in the program are wide ranging. In addition, they take care of the immediate pressures but also they strengthen the public stance in a longer horizon. In any case, the authorities should pay keen attention to execute all the actions related to the provinces public finances and their borrowing. An issue that was not clear to me and where staff clarification would be useful is in relation to the "recognition of past liabilities". How large are those liabilities? How are they constructed?

In the financial system Argentina has done a superb job and I venture to say that they are setting the standards for Latin America and the emerging markets in general.

I sense that a lot still needs to be done in the labor market to increase competitiveness and make employment more resilient to external shocks. Hopefully the proposed reform on labor legislation will be approved by congress without distortions, given the urgency to increase labor productivity, to create employment and, as important, to shield existent jobs from future shocks that might come along. I would appreciate if Mr. Zoccali and the staff could comment on what else could be done in the future to improve the workings of the labor market, given the importance it has to preserve the public support to the actual economic strategy.

To close, I would like to compliment staff for the excellent material provided for today's discussion. It reflects both a clear understanding of the key issues regarding Argentina's economy and the frank dialogue with the authorities. With this remark, I would like to reiterate my support to Argentina's request for a Stand-By Arrangement.

Ms. Lissakers asked whether the NDA ceiling in effect constituted a tightening of the currency board rule, in that it removed some of the leeway provided by the Convertibility Law to substitute domestic public debt for hard currency backing for the domestic currency.

The Deputy Director of the Western Hemisphere Department noted—in relation to the possible reform of the tax system that could encourage more workers back into formal employment—that the personal income tax was not a deterrent to employment in Argentina, in contrast to the situation in some European countries. Moreover, at $21,500 per year for each household, the exemption level was generous. A more significant impediment to unemployment was perhaps the level of Social Security contributions, although they had gradually been reduced over the past few years. The last significant set of reductions had taken place in 1999, and a further reduction of one-third of the current amount was contemplated in the labor reform law for marginal additions to employment of the payroll enterprise. The authorities were conscious of the need to reduce the fiscal wage as much as possible in light of overarching fiscal constraints. They were also taking some specific measures to encourage the self-employed to participate in the Social Security system, by allowing better coverage for the self-employed and for domestic workers.

The binding ceilings on the level of the consolidated public sector debt could, indeed, put an undue burden on the federal government to compensate for slippages in fiscal discipline among the provinces, as Mr. Pickford had suggested, the Deputy Director agreed. However, the existence of a binding ceiling was the best incentive for the federal government to use effectively and forcefully the instruments of control over borrowing by the provincial governments. In the past there had been only indicative ceilings, which contributed to a somewhat more accommodating posture on the part of the federal government in that respect. Another important point was that the existence of a binding ceiling would require improvements in the monitoring system in place of the greater dissemination of that information, thus contributing, vis-à-vis those provinces with market access, to greater market discipline.

Messrs. Faini and Schlitzer were right that the rise in unemployment since 1999 reflected, to a large extent, the increase in the labor force rather than a decline in employment, the Deputy Director confirmed. The increase in the labor market participation rates had been primarily among secondary bread winners, supporting the view that Mr. Faini had advanced in his statement, the staff representative reported. There had been a deterioration in the economic conditions of poor households. A detailed breakdown of the unemployment data would be available three times a year in the future.

In that sense there was no inconsistency between the labor reform legislation and the ILO convention on collective bargaining, the Deputy Director noted. The proposed labor reform legislation would increase the role of collective bargaining both in terms of providing more scope for decentralized bargaining—which was essential to provide greater flexibility to the labor market—and by eliminating Ultredad's existing contracts. The staff was not in a position to provide Directors with the list of the countries that had adhered to the ILO convention.

The proposed labor legislation would go a long way toward improving the labor market, if it passed the Senate without being watered down, the Deputy Director considered. Some modest changes had been made in the upper house, in particular: the probation period for other than small and medium-term enterprises had been shortened from six months to three months. Nevertheless, the legislation offered scope for considerable flexibility in the labor market. That did not mean that other measures could not be taken, such as the professional training and retraining of workers, which could help in promoting better supply and demand in the labor market.

As to whether Banco Nación was the appropriate vehicle for channeling smaller and medium enterprises, the staff considered that the concentration of a Bank activity in a particular sector or category of enterprises was not healthy, the Deputy Director commented. Nevertheless, in the past the highest percentage of nonperforming loans of Banco Nación reflected loans to large corporations that were essentially the product of political pressure. The proposed legislation would require larger borrowers from the Banco Nación to obtain at least two credit ratings from reputable credit rating agencies. That would represent some safeguards in that respect, as would the transformation of the Banco Nación into a state-owned corporation that would increase the transparency of its operation. That was why the staff attached importance to that measure and introduced it among the structural benchmarks of the program.

Regarding the high level of nonperforming loans, the standards for qualification for bank loans were quite high in Argentina, the Deputy Director stated. The system of rating credit-worthiness was sophisticated, and bank supervision had been substantially strengthened, so it was possible that intracountry comparisons would tend to overstate the level of Argentina's nonperforming loans vis-à-vis other countries that applied less stringent standards. Furthermore, there was reasonably high provisioning of those nonperforming loans; out of the 11.5 percent of nonperforming loans, more than seven percent were adequately covered. The increase in 1999 had not been dramatic, considering the depth of the recession and the impact of the terms of trade loss on certain export sectors. The staff certainly intended to focus more on other factors that might impinge on competitiveness, such as the degree of sectoral monopolies, and the reduction of tariffs and other non-labor costs.

On debt consolidation operations, Box 1 in the staff report explained the types of operations that gave rise to the need for securitization of claims against the Social Security Administration for pension claims that had not previously been recognized and other claims involving the federal government, many related to suppliers' credits, the Deputy Director noted. The authorities' best estimate was that, over the program period, those loans recognized by the courts would amount to about $4.5 billion. Nevertheless, it was a dynamic process, and somewhat outside of the authorities' control, thus they could influence the timing, but not the amount of debt recognition. There might be a need for adjustments as a result of future court rulings.

Regarding export performance and whether diversified geographical destinations would have helped moderate the effects of the regional recession, there was no doubt that directing Argentine exports to countries in Europe or to the United States would have helped moderate the impact of the recession on MERCOSUR, the Deputy Director commented. However, in 1999 there had been 30 percent growth, and exports to Europe had grown at a more modest but nonetheless positive rate. The combined share of exports to NAFTA and the EU rose above that of MERCOSUR, shifting it from 27 percent to 34 percent.

Mr. Faini commented that Mr. Carstens had correctly underlined the urgency of reforms to shield employment from the impact of exogenous shocks. Figure 1 showed that employment had been quite resilient despite the recession; the question was whether this was because there were major restrictions and high costs which projected the economy from exogenous shocks, or if the labor market was flexible enough to allow for the shocks.

The Deputy Director of the Western Hemisphere Department replied that both explanations were plausible, but the first probably had more weight. The labor market in Argentina was more flexible than it appeared, but that was because much employment generation took place through informal markets, which entailed costs in terms of tax revenues and the potential burden on the social security system in the future, when those people without adequate social security coverage might request assistance.

Wage flexibility and shifts to the informal labor market could not explain the pattern of employment, the Deputy Director continued. The employment figures included both the formal and informal sectors. There was no question that despite the reductions in severance costs as a result of the previous phase of the reforms, severance costs were still considerable and prevented short-term employment creation.

Mr. Palei observed that Directors had expressed different opinions about the fiscal forecast. Some had thought that the program was appropriately ambitious while others believed that there was room for fiscal tightening. Were there contingency plans in case that tax administration turned out to be better than was currently envisaged?

The Deputy Director of the Western Hemisphere Department replied that the degree of ambition of the program could be judged in different ways. Looking at the primary balance, the effort appeared to be quite substantial, and the primary balance targeted for the year was better than that targeted for 1999 in the original EFF program. It could also be argued that, given the prevailing interest rates and the high debt, it was necessary to do more, and the authorities recognized that. The degree of ambitiousness also took into account the fact that nearly 50 percent of spending was in the hands of sub-national governments. Most transfers to the provincial governments were mandated by the federal pact, based on the previous year's level of transfers, albeit below the level that would have been required in the absense of the pact. Therefore, the federal government bore the brunt of the adjustment.
For 2000, a rate of growth of three and a half percent, if achieved, would be well below what Argentina had achieved during the 1990s as a whole, but could be considered a reasonably ambitious adjustment. The calculations of the fiscal imbalance suggested that the budget

would exert a significant negative impact on demand in 2000. That impact was already being felt, as, although exports were increasing, consumption was apparently not recovering.

The authorities recognized that perhaps more could be done in 2001 and 2002 than currently envisaged under the program, the Deputy Director continued. However, they did not want an over-ambitious target that might jeopardize their credibility. There was nevertheless an understanding that if revenues increased and the economy was stronger, then the gains should be used to reduce the deficit and the debt more quickly.

The staff representative from the Western Hemisphere Department said that Ms. Lissakers was correct that the NDA target formally removed the leeway built into Argentina's Currency Board Arrangement. By ensuring in normal times full coverage of the money base, which was what the NDA target would do, it would prevent emergency assistance as permitted, in case of a crisis, by the rules of the currency board. It was difficult to have it both ways.

On trade policy, the stated intention of the member countries was to deepen MERCOSUR, the staff representative commented. The authorities were in the process of formulating the relevant policies, which would map the way forward. The intention was to bring Chile in soon.

The constitution strictly forbade the Banco Nación of Buenos Aires from being privatized, the staff representative reported. Meanwhile, the Bank was run on terms largely comparable to private banks. Its prudential ratios were in line with the rest of the ratios of the well-run banks in the banking system.

The staff representative from the Policy Development and Review Department said that the Fund did not keep track of the list of countries that abide by the 1998 ILO collective agreement.

Regarding how the staff and management had determined the amount of Fund support and what kind of vehicle was considered most appropriate, the country had had enormous difficulties for a decade ending in 1989-1991, but had had a rather exceptional track record since then, the staff representative recalled. Mr. Bernes had listed the series of arguments, which were in keeping with both the letter and the intent of the access guidelines that were in place, despite an aberration in 1994-1995. The staff was dealing with a situation where performance had been extremely strong on the structural and macroeconomic side, followed by slippage caused both by a set of adverse external circumstances that affected the current account more than the capital account, and domestic slippages in the past quarter. The question was how to provide support to a new set of authorities, who were determined to move quickly, and to live up to the strategy that had been developed over the past ten years. The staff had rapidly come to the view that the strength or ambition of structural reform policies justified high access under the 1983 guidelines.

There was a certain justice in accepting some floating of the first purchase, the staff representative stated. If Argentina had decided to stay under the EFF, but had also come up with the subset of policies, Directors would have probably accepted the augmentation and agreed to the waivers and modifications of the program, to allow for the release of the resources accumulated under the EFF in the previous 18-month period. Thus, the staff had few qualms about access. The level was in keeping with that of other countries with strong programs that had been decided by the Board, including Turkey, Mexico, and Colombia.

There was another consideration related to Mr. Bernes's concern that placing too much emphasis on the catalytic effects of large challenges might prompt a "rush for the exits" if the program went off-track, the staff representative continued. First, if the program went off-track, there were no resources available to Argentina from the Fund without consultation and discussions of proactive policies. However, the access guidelines recognized that substantial Fund financing was frequently a critical element in restoring the confidence of the international financial community in the policies of a country and thus reviving or maintaining capital flows. That consideration could not be completely disregarded.

Regarding Mr. Milleron's reservations about the precautionary nature of the arrangement, when the country was relying heavily on the financing of multilateral development institutions, the Fund did not view its financial involvement as a case of burden-sharing with other sources of financing, the staff representative remarked. The Fund's support was intended to catalyze other sources of financing and give confidence to members, not to "cut the pie into pieces."

The Board would have a preliminary discussion on the matter of choice of support provided by the Fund the following week, the staff representative noted. The EFF was designed to support economies suffering serious imbalances, with widespread trade and cost distortions, or economies characterized by slow growth and inherently weak development policies. Argentina did not particularly fit those descriptions.

Directors would also revisit the issue of the CCL, the staff representative commented. The situation in Argentina was slightly complicated because the country could not currently claim, as required under the CCL, an absence of need to use Fund resources or say that its policies were being strengthened. To a certain extent the second CCL criterion was satisfied: there had been a somewhat qualified positive assessment by the Fund of the situation in Argentina at the time of the previous Article IV consultation. However, it was not enough for the policies to be judged positively at the time of the previous Article IV consultations. The country had to continue to be assessed favorably by the Fund thereafter, based on economic indicators of domestic stability and external sustainability. That had not been the case in Argentina in the last quarter of 1999, even though policies had improved considerably since then. Argentina certainly met the other two criteria, as Mr. Milleron had suggested, but it was not the time or place to discuss the issue in detail, although the matter needed to be pursued in the discussion the following week.

Mr. Milleron asked for a better understanding of the precise reasoning used to arrive at the substantial amount of the program, $7.4 billion over three years. What was the basis for the staff's assessment?

The staff representative from the Policy Development and Review Department [Brachet] replied that there was no hard and fast rules to determine access. The staff exercised a measure of judgment, taking into account the guidelines, the country's need, the annual access limits, which were 100 percent of quota, the country's track record, and its position and history of repayments to the Fund. Moreover, in the case of the CCL there was no limit on access, while with ordinary resources the staff was constrained by the access limits. Thus, there was some judgment involved in determining access in individual cases. The average access rate was currently about 44 percent or 45 percent, but there were cases of strong policies that had mobilized larger access.

Mr. Zoccali made the following statement:

> I will keep some of my remarks for the end, but on this point, I should emphasize the importance of the policy commitments rather than the access level. The access amounts are equivalent to 85 percent of quota in annual terms, and should be assessed against Argentina's completely open capital account, the fact that its economy functions without any capital or exchange controls and the precautionary character of the envisaged Stand-By Arrangement. In this context, this is a relatively small amount of potential support to ensure that its policies can be implemented successfully, keeping in mind that the sustainability and reduced vulnerability of the Argentine economy will ultimately depend on the success of policy implementation.
>
> I would also like to answer Ms. Lissakers on the timing of the reform proposals. As was noted in the policy memorandum of understanding a fairly ambitious sequencing was established, that includes the strengthening of tax administration, the follow-up reform of social security, and additional legislation leading up to the reform of the revenue-sharing scheme, to which she has alluded. If anything, there is anxiousness, particularly at the level of the president, to see these reforms implemented quickly. This, however, is being done in the context of the institutional division of powers that operates in Argentina. Since most of these reforms are expected to be implemented during the first two years of this administration, this should be seen as a rather ambitious program.
>
> On MERCOSUR, in addition to what the staff has mentioned, it is the political priority to improve the integration prospects within MERCOSUR. At the more operational level, conversations have started on the harmonization of statistical date bases and of the regulatory and prudential structures of the financial systems. More generally, the view is to facilitate dialogue, to ensure better coordination and macroeconomic convergence.

Mr. Faini noted that the Fund did not, at that stage, have the right facility available for a country like Argentina. The country had suffered some slippages, but was committed to undertake a strong program, both on the macroeconomic and the structural reform side, and was thus willing to treat arrangements as precautionary. Stand-By Arrangements would not normally be the vehicle for that kind of situation, there were reservations about treating the EFF as precautionary, and the country was not eligible for the CCL. Thus, there was a gap in the toolkit, which needed to be considered when the Board undertook the review of Fund facilities. Even if there was an appropriate tool, it was not clear that the country had the right incentive to use it. The Stand-By Arrangement carried a lower rate of charge than the CCL, and the commitment fee could be refunded under the Stand-By Arrangement but not under the CCL, which did not increase the attractiveness for what could be the facility for the best performers.

Mr. Donecker said that it was important to look at the Stand-By Arrangement, the Currency Board Arrangement and its sustainability, and the question of the amount of the arrangement. It was critically important to rapidly increase the flexibility of the labor market, otherwise there might be great difficulties.

The Acting Chairman pointed out that labor market reform was one of the most critical issues for the previous government. Like many others, management had been reasonably skeptical about the new government's commitment to labor market reform, but the fact was that it had sent the labor law to the congress quickly, certainly before management had expected. The fact that the legislation had already been passed by the lower house also indicated that the government considered the issue critical. The minister seemed reasonably confident on the prospects for passage by the senate. Most encouraging to management was the fact that there had been so many moves without prodding from the Fund.

Mr. Zoccali made the following statement:

> I would like to confirm this explanation that you have given, Mr. Chairman. In fact, my authorities believe that this labor reform package can be enacted rather quickly. As you know, the draft originated and was approved by the Lower House, where the Alianza has a majority. In the event of a change in the bill by the Upper House, it would return to the Lower House where it originated and its version could be approved on the basis of a simple majority. Therefore, the prospects for the labor reform to be enacted in the next few weeks are large, and my authorities are confident that this will be so.

Ms. Lissakers said that she was worried about the policy mix, particularly the emphasis on labor market reform, because it would not produce the desired result in terms of job creation if it were not accompanied by significant deregulation and de-protection of large parts of the business sector, which remained protected, with large profit margins, and uncompetitive, for lack of competitive pressure from external markets. The concern was that the Fund would in effect have promised the workers that there would be job growth, despite downward pressure on wages as a result of the adjustments. Instead, there would be less job security, and employment creation would be weak because other pieces of the package were not in place. For instance, rapid trade liberalization, which was an important issue, was not foreseen. There was clearly an interest on the part of the authorities to increase integration in

MERCOSUR, but the policy package did not present any ambitious deregulation or elimination of protection for key industries unless protective measures were eliminated, yet there would be no employment growth. A currency board could not be politically sustained by placing the entire adjustment burden on workers.

Mr. Kiekens strongly supported Ms. Lissakers's views. There was an urgent need to have better dialogue with workers to explain not only why adjustment was necessary, but to clarify the additional measures that were needed to create employment. Otherwise, the political sustainability of the program would be at risk.

Mr. Donecker agreed with Mr. Kiekens and Ms. Lissakers.

Mr. Zoccali made the following statement:

> I would not like to leave the impression that my authorities, in Argentina, are sitting idly waiting for the labor reform to occur and that nothing else is being done in the area of deregulation. In fact, agreements were negotiated with the privatized telecoms basically to improve competition in the sector. One must remember, however, that some privatizations took place in unfavorable circumstances and that in order to attract the private sector investors in the first place, some inducements in terms of profitability had to be built in. As contracts are maturing, negotiations are taking place to improve the competitive environment. In fact, these have already produced reductions in telephone rates of around of around eight percent. This process is continuing with further deregulation in the gas sector, where the expected rate reductions are in the 20 and 25 percent range, and as well in other important services. My authorities are very conscious of the need to ensure that the non-tradable sector does, in fact, contributes to enhancing competitiveness, but they are also intent on respecting the contractual agreements in place, and are carefully going about this so as not to violate contractual provisions or create judicial insecurity as a result.

Mr. Carstens agreed that Ms. Lissakers, Mr. Kiekens, and Mr. Donecker had been correct in suggesting that the Argentine authorities should open up trade. Mexico had made opening up its economy a key point in its economic program, and that had worked well. However, the strong appreciation in the real exchange rate that Argentina had suffered was equivalent to a rapid opening of the economy. Even without tariff incentives the Argentine productive sector had been under considerable pressure and it was not clear that exchange rate appreciation would unwind soon enough. Argentina was encouraged to open up but there was a need to recognize that the country had been making great efforts in the productive sector, and had shown a great capacity to adapt to difficult circumstances.

Mr. Kiekens pointed out that exports accounted for only 10 percent of the Argentine economy. There also needed to be employment creation in the sheltered domestic sector.

The Deputy Director of the Western Hemisphere Department said that while Argentina was not among the most liberalized economies in the hemisphere, staff comparisons showed that in terms of openness, Argentina was in the middle: not particularly restrictive and not particularly open. Non-tariff barriers, except for in the automotive and footwear sectors, were relatively low. As regard external tariffs, Argentina could push for liberalization within MERCOSUR, including a faster reduction of the Common External Tariff, but it could not act unilaterally.

As Mr. Zoccali had mentioned, Argentina was trying to promote greater competition internally through deregulation and by reducing existing monopolies, the Deputy Director reported. The authorities were also looking to achieve greater integration in MERCOSUR, while progressively opening it up to the rest of the world.

The staff had some sympathy for Mr. Carstens's view that it was not the best time for Argentina to push strenuously for trade liberalization, the Deputy Director acknowledged. The country was trying to absorb the impact on its external accounts of the large effective appreciation of the exchange rate, reflecting not only the devaluation of the Brazilian real but also the strength of the U.S. dollar. The staff had been emphasizing to the authorities that protecting industry was not necessarily the best way to accomplish that objective over the longer term, but the authorities did not agree. In addition, there was an alliance of business and unions against the liberalization and opening up of the economy.

Ms. Lissakers remarked that the staff's information was not surprising, but Argentina was in a dilemma, because its currency board had a cost. It was not politically sustainable to put that cost on the labor sector, and, to some extent, that was what was happening in protected segments of the economy. Even with the appreciation of the currency, given the level of protection, there were a number of industries, while high profit margins, that were not competitive in terms of their production methods and quality of product, but were not threatened by imports. Automobiles were one such product, with major beneficiaries being the U.S. car companies. Argentina needed to look at Chile not just as an attractive partner for MERCOSUR, but to examine how it had escaped the trap that Brazil and Argentina fell into every time the current account went out of control. Despite the major reforms that had taken place over the past few years, Argentina had again not escaped that trap.

Mr. Zoccali made the following statement:

> My authorities would agree with Ms. Lissakers that the cost of adjustment should not fall on labor, and that employment creation is a priority of their program. It is also their priority to re-establish confidence, which is a pre-condition for growth that, in turn, should positively impact on the level of employment and employment creation.
>
> Second, the external environment has not been particularly favorable to Argentina, not least because the possibilities of placing traditional exports in which the country has a clear competitive advantage have been hampered by resort to non tariff barriers and to producer subsidies or support schemes in

agriculture in more advanced countries. In this regard, many of these countries have not been a paradigm for trade liberalization. What is important is that notwithstanding this, Argentina has been trying to address distortions and emphasize deregulation and structural reforms throughout the 1990's. As a result, costs have declined quite significantly in certain areas. In the tradable sector, one must also recall that import tariffs were reduced, in particular on capital goods from outside MERCOSUR to zero. In the context of the fixed exchange rate under the CBA, this spurred investment after many years where it slightly exceeded the level of depreciation. This suggests that there is an element of substantial catching-up as regards to investment. The fact that there was instability, institutional and otherwise, contributing to the process or the causality of capital outflows during many years, also signified that substantial foreign assets were built up by local residents. This, in some respects, explains why external financing returns quickly in the context of confidence. It is to be established whether the level of the current account deficit is an ex-ante restriction, since it is the availability of adequate financing and of satisfactory terms, that has been driving the prospects for investment and growth in Argentina. During this catch-up period, the current account of the balance of payments should, therefore, be expected to reflect the structural modernization of the economy.

In sum, there is a competitiveness strategy in Argentina that includes full integration to world capital markets, deregulation, and a possible new reduction in some capital good tariffs.

Mr. Faini said that he supported Mr. Carstens's views. He also agreed with Ms. Lissakers and Mr. Kiekens that labor market reform could be frustrated by a lack of competition. According to paragraph 45 of the staff report, Argentina was taking measures doing something to promote competition in its product market, which could improve growth and employment prospects. The question was whether trade liberalization efforts were needed to complement the strengthening of competition. The short-run impact of trade liberalization and trade reform could be expected to be generally positive. However, reducing tariffs would not necessarily increase employment in the export sector.

Mr. Donecker also agreed with Mr. Carstens. Argentina was especially limited by its link to the dollar. It was a difficult choice, but if the country wanted to maintain the link to the exchange rates, then it had to accelerate reforms, particularly to liberalize markets and to make labor markets more flexible.

Ms. Lissakers asked whether Directors were arguing that Argentina should not liberalize its trade regime any further because it had a currency board, and the dollar was strong. She disagreed with Mr. Faini's comments on trade liberalization and employment. The U.S. economy was currently as open as it had ever been. It was not perfect, but the strongest employment growth and job creation had been in the most open and unprotected sectors. It was also useful to look at the encouraging developments in Mexico, where there had probably been the most opening up and the most competition. The policy mix had to be questioned if the Board was coming to the conclusion in Argentina's case that the country could not afford to open up because it had a currency board.

Mr. Carstens commented that he would not encourage the Argentine authorities to stop liberalizing their economy. However, it was a question of timing; the authorities had taken steps in the right direction, aimed at making the economy more efficient. The reforms would encourage further reforms. It was not also a matter of waiting for the dollar to depreciate against European currencies or for the Brazilian real to appreciate further. The authorities had to internalize their currency board, and to prepare the economy to face the changed circumstances, by promoting trade liberalization and further fiscal adjustment. The greater the fiscal adjustment, the more stable interest rates would be, and that would also make the country more competitive.

In order for the program to have public support, it was important to allow time for some of the measures to be implemented and to yield results, Mr. Carstens considered. That was the stage that the authorities were at, and as the program progressed they could be asked and expected to further liberalize the economy. A gradual approach would work better for the time.

Mr. Pickford commented that there was a need to build support for trade liberalization among strategic interests. As Ms. Lissakers had said, trade liberalization was one of the most important ways in which domestic business could become more competitive, providing a spur that in itself would build in a positive dynamic. Regarding Mr. Carstens's suggestion that there was a need for a gradual approach, it would be inadvisable that there should be a pause or an extended period in which nothing happened.

The Acting Chairman said that no one appeared to be arguing against Argentina's opening up, certainly not the Argentine policy makers to whom he had spoken. Labor market flexibility was believed to promote higher employment, as was trade liberalization, although the unions had yet to be convinced, judging by the demonstrations surrounding the World Trade Organization meeting in Seattle. Thus, there was a political problem that went beyond the labor market measures in the face of powerful unions. In the past week, Mr. Zoccali and the Acting Chairman had met with one of the influential economic advisors in the Argentine government, who had put that at the top of his priorities. Pressure from the Board in that direction would help in terms of the long-run development of the Argentine economy.

Mr. Toyama made the following statement:

> This chair supports the proposed decision, but will comment briefly.
>
> The Argentine authorities are to be commended for their efforts at economic reform during the 1980s up through the mid-1990s. Some progress was made under the SBA and EFF programs during that time, reflected in the fact that hyperinflation has disappeared and the economy has been liberalized in legislation, privatization, trade, and capital transactions. Meanwhile, the fiscal position is still vulnerable and the labor market lacks flexibility. It is

clear the authorities' efforts were hindered when faced with an unexpected crisis, such as occurred in Mexico, Asia, Russia, and Brazil. However, it is regrettable that the current EFF program was off-track in the fiscal deficit, as shown in the adverse impact of the Brazilian crisis and expenditure overruns following political elections. That said, the current poor performance was not only caused by deterioration of the external environment. This poor progress is in contrast to Asia, which saw an early recovery.

To build a resilient economy, it is important to facilitate structural reforms to improve competition and to develop a business foundation in non-traditional sectors by making information technology accessible. In this regard, I hope the authorities will actively tackle further economic reforms in order to graduate from the Fund program at the conclusion of this SBA program.

Given the poor track record on the fiscal deficit, and relying on external financing to fulfill the current account deficit, I welcome that the FY 2000 primary fiscal balance aims to improve by 2 percent of GDP in the program by implementing several fiscal measures as described in the staff paper, such as a tax package and a revenue-sharing system between the federal and provincial governments.

Staff estimated that the contractionary impulse of fiscal retrenchment to domestic demand is expected to be at about 1.7 percent of GDP in FY 2000, and could be offset by the positive impact of the increased availability and lower cost of financing for private sector borrowers, resulting in a feasible projection of the FY 2000 GDP of 3.4 percent. However, it might take some time for this positive impact to appear. Although economic indicators showed the economy bottomed out last July, given the current fragile economic situation, rapid fiscal consolidation might undermine recovery. I would like to point out that the staff projection is too optimistic. Moreover, given Argentina's vulnerability to external shocks, attention must be given to downside risks in the case of an economic downturn in Brazil and the United States (closely-related countries).

Wholesale prices increased this year, mainly due to increasing oil prices. I understand that in staff's view, this rapid increase will have little impact on consumer prices. But I wonder whether higher oil prices will not actually force inflation on the economy. Further staff comments would be appreciated.

Finally, I would like to raise the same question on the precautionary SBA as we did at the Board discussion on Estonia. If I understand correctly, staff explained that the appropriateness of the amount of purchase of the precautionary SBA was determined by the strength of the program and that in general between 30 to 60 percent of quota in terms of annual access was appropriate for the precautionary SBA. On the other hand, a three-year SBA in the amount of 255 percent of quota, 85 percent in terms of annual access was proposed for the precautionary SBA, despite more favorable conditions regarding access to external financing as well as lower financing costs. I would like to hear more from staff on this.

Mr. Schaad made the following statement:

I commend the Argentine authorities for the verve with which they address partly long standing policy issues since the change after the last elections. This is a dash to tackle politically difficult changes of which the country could greatly benefit. Examples are fiscal structural reform, inter alia leading to a better interplay between federal and provincial fiscal policy; and important reforms in labor market policy, giving the labor market more much needed flexibility. These are of general merit, but they are crucial in Argentina's monetary policy framework. The slippages that led the last EFF to fail are regrettable. However, I feel that this is a fresh start and there seems to be no lack of program ownership and commitment on the part of the authorities. Indeed, the authorities have already moved ahead in implementing certain measures that are included in the new program. So, I support this new Stand-By Arrangement. I also welcome the authorities' intention to use this SBA as a precautionary arrangement. This arrangement, together with the hitherto successful strategy of borrowing ahead of actual needs, should help authorities to implement the important reform agenda and to put the Argentine economy back on a path of sustained growth.

The achievements of the last decade are impressive. The present monetary regime has guaranteed stability and created an environment conducive to private saving and investment, and to foreign capital inflows. However, a closer look at the second half of the decade reveals remaining structural weaknesses. Growth slowed markedly over the years running up to the Brazilian crisis, external indebtedness has risen significantly, with the debt to exports ratio now among the highest in Latin America, and competitiveness of the export industries remains weak.

Today, the outlook is not without risks: monetary policy in the U.S. will most likely tighten, and I would not count too much on a weakening of the U.S. dollar. So, I agree with staff in its assessment that the real appreciation of the real will not be totally reversed in 2000. Further, the necessary fiscal tightening will no doubt dampen the recovery.

Let me now turn to the program: To address the worrying increase in consolidated government debt, fiscal consolidation and deeper structural fiscal reform is most important and welcome. Here the federal authorities' virtuosity in putting provinces on a more sustainable fiscal path despite legal constraints deserves special mention. This is in fact creating the prerequisite for controlling consolidated fiscal spending and, under this program, to meet the performance criterion on consolidated fiscal debt. The introduction of a new revenue sharing regime with the provinces is a good step forward in a difficult field, and I encourage the authorities to mold this still temporary measure into a more permanent solution in time before 2002. Progress has also already been made in other, equally important areas, such as tax administration and public expenditure management. The recent granting of a tax moratorium, however, points to the possibility that the ride may not always be smooth. Sometimes a step back is necessary to prepare for a leap. However, in this case I am not sure where the leap will go. As is well known, while a moratorium may serve the goal of higher revenues in the short term, it may well undermine tax compliance in the future.

I now turn to labor market reform, the second, equally important building block of this program. Increasing the flexibility of the labor market will be critical to improve external competitiveness and the overall economic outlook, especially in the current monetary policy setting. The presentation to Parliament of the recent Reform Bill is therefore highly welcome. Reducing employers' social security provisions and discontinuing severance payments for newly hired workers are set to facilitate employment in the early stages of economic recovery. Giving labor agreements at the firm level more legal weight relative to sectoral agreements is also a step in the right direction and should reduce the as yet high centralization, and thus the high costs, of collective bargaining. I think that the attention to be paid to labor market reform in the first review of program implementation is fully justified.

At the same time, I share Ms. Lissakers', Mr. Kiekens' and others' concern that product and service markets need to be opened to competition from within and without Argentina, so that the labor market will not have to bear the brunt of macroeconomic adjustment alone.

Turning to the monetary side, I take note of the authorities' further commitment to the present currency board regime. I agree that nominal depreciation of the exchange rate would be an inadequate way to seek to increase external competitiveness. This would not be the moment to incur the risks of getting off a regime that has no doubt served Argentina well. We do not know how an exit from a currency board looks like in calm times, let alone in the middle of efforts of stabilization and deep structural reform. Given the high degree of de facto dollarization of the banking system and the large share of dollar-denominated public debt, the benefits of a devaluation could even be quite limited. However, Brazil's devaluation and the recent strength of the US dollar have no doubt let Argentina feel the downside of the limited possibilities of a regime as rigid as the present one. In general, no exchange rate regime should be set in stone and hence not even the Argentine currency board. Further down the road, in a post-stabilization environment, it may well be that a more flexible exchange rate regime serves Argentina better than the current regime. This is something to think about in the long term, and it goes without saying that a change will require extensive preparation of an alternative monetary regime, including building up the institutional framework and capacity to conduct stability-orientated monetary policy, as well as public confidence in such capacity.

Finally, although I think that the current SBA is fully justified, I had some second thoughts on the large access this Stand-By Arrangement permits. The staff report suggests that large financial support by the Fund will serve as a catalyst for private sector financing. I am not sure that this is the kind of catalytic effect this Chair would like to promote. We would mainly like to see the policies implemented under a Fund-supported program to serve as a catalyst and less so the money available. It is dangerous to convey the message that the Fund endorsement of a program is proportional to the funds extended. In this sense I fully share Mr. Bernes' concerns on this issue.

With these comments I wish the Argentine authorities success in their reform efforts.

Mr. Alosaimi made the following statement:

1999 was a difficult year for the Argentine economy. Buffeted by a number of external shocks, GDP contracted, the fiscal position weakened, and public debt increased. However, as these developments underscored the soundness of the financial system as well as the authorities' commitment to their policy framework. This can only enhance investor confidence and strengthen the ongoing recovery. The authorities' three-year program should further improve the outlook. Indeed, as Mr. Zoccali notes, the recession has bottomed out and the projected growth for 2000 now appears conservative.

I am in broad agreement with the program's priorities and will limit myself to a few comments for emphasis.

I welcome the priority for sustained fiscal consolidation. In this regard, the program for 2000 offers an impressive start. The focus on expenditure reduction and on strengthening fiscal performance at the provincial level is reassuring. On the revenue side, I endorse the efforts to strengthen tax administration and to reform revenue sharing regimes with the provinces. However, I share the concerns regarding adverse effects of a tax moratorium on future compliance.

I am encouraged by the authorities' cognizance of the risks in tightening fiscal policies this early in the recovery. However, in the case of Argentina, those risks are likely to be offset by the benefits of higher confidence and lower interest rate spreads. The upgrading by Standard and Poor's and the renewed interest in Argentine debt are encouraging signs in that regard. The authorities' continued active liability management policy and their efforts to facilitate involvement of the private sector should further improve prospects.

That said, it is essential for Argentina to fully achieve its fiscal target. In this regard, a rise in international interest rates is an important risk. Moreover, the benefits of the fiscal consolidation efforts are backloaded. While this backloading is understandable for the reasons detailed in Box 7, it will still likely make the markets less forgiving of any slippage. Therefore, the authorities need to be extra vigilant and stand ready to implement additional measures if needed.

In addition to strengthening the fiscal position, it is clear that enhancing Argentine competitiveness depends on advancing structural reforms. The labor reform proposals along with other reforms detailed by Mr. Zoccali and staff are reassuring steps in that regard.

Turning to the external sector, I agree with the authorities' continued firm commitment to the convertibility regime. Indeed, seeking to improve competitiveness through a nominal depreciation at this time is a risky undertaking for the reasons detailed in the staff paper. I also endorse the authorities' commitment to an open trade regime and urge them to resist protectionist pressures.

With these remarks, I support the authorities' request for a Stand-By Arrangement and wish them further success.

Mr. Kiekens made the following statement:

The Argentine authorities have ruled out a change in the exchange rate regime as an economic policy option. Therefore Argentina's great challenge will be to achieve a viable external position through fiscal consolidation and structural adjustment. This will require Argentina's productivity to increase faster than that of its trading partners whose currencies are depreciating vis-à-vis the peso. It will also require further reducing financial vulnerabilities so that investments can be financed and the existing debt stock rolled over at the lowest possible cost.

Argentina's gross balance-of-payments needs during the program period will exceed $100 billion, as shown in the useful Table 10. This is in addition to the need to roll over short-term external debt of about $20 billion. These numbers alone show how crucial it is for Argentina to enhance its credibility, reduce its vulnerabilities, and increase its private savings.

During the last eight years, the policies Argentina has implemented have by and large been the right ones. These include important structural reforms such as privatization, deregulation, overhauling the financial system, liberalizing international trade and capital flows, reforming the pension system, and the successful operation of a currency board to ensure price stability. But even after all this—as pointed out by Pedro Pou, president of the central bank, during a conference at the Federal Reserve Bank of Boston last summer—even after eight years of playing by all the rules, Argentina still lacks a national currency that can be used as a long-term store of value. As a result, Argentina, like most other emerging markets, can satisfy its strong need for capital only by attracting financing in its own currency for the short term, or in foreign currencies for longer-term maturities requiring substantial risk premiums. Argentina is thus exposed to a substantial twin mismatch involving large liquidity and currency risks that could lead to simultaneous banking and currency crises.

Obviously, we would not recommend that Argentina impose restrictions on international capital flows as a way of reducing currency risks, and the authorities do not plan to do so. But it is of paramount importance to pay attention to the maturity structure of Argentina's external debt. Like Mr. Pickford, I think that the management of Argentina's external debt should be one of the central preoccupations of the government's policies, to be closely monitored by the Fund. However, I would not go as far as Mr. Pickford by requiring performance criteria in this connection.

Contingent credit lines for meaningful amounts will help Argentina reduce its financial vulnerabilities, provided such credit supports strong policies. The policies outlined in the Letter of Intent deserve the Fund's support. The amount of the arrangement is justified by the magnitude of the gross balance-of-payments needs I mentioned earlier. I would have preferred to see the amount of the access explicitly justified in the staff report, but I applaud the inclusion of the very useful Table 10 documenting the country's balance-of-payments needs.

The report justifies the frontloading of access by the frontloaded character of the policies, and by the need to partially make up for the accumulated undrawn amounts that Argentina will forgo by canceling the present extended arrangement. I agree that it could be useful to establish a policy of carrying over a part of a member's accumulated undrawn amounts into successor precautionary arrangements. But it seems questionable whether the policies being considered today are indeed frontloaded. I will return to this topic later.

As Mr. Milleron also mentions, Argentina's previous program went off track, and the policy slippages and shortfalls in structural reforms have not yet been fully corrected. It is therefore doubtful that there is a valid argument for carrying over part of the accumulated undrawn amounts from a previous arrangement. Mr. Faini and Mr. Schlitzer have a point when they observe that it would have been preferable for the structural measures missed under the EFF to have been made prior actions for today's arrangement. Nonetheless, all this is a matter of judgment and I can go along with yours, Mr. Chairman.

Mr. Milleron further doubts that the arrangement should be precautionary in nature. He argues that this will distort the burden-sharing between the Fund and the World Bank. I agree that the precautionary nature is an issue. However, we should not approach it from this angle. Each IFI has its own rules. Correct application of these rules by one IFI should not be considered as unduly increasing the "burden" on other IFIs. But the issue whether Argentina's arrangement should be precautionary is nonetheless a meaningful one. Except during acute currency crises, emerging market countries nowadays have access to financial markets to finance all their balance-of-payments needs, albeit sometimes at high risk premiums. It is still unclear what criteria the Fund uses to decide that a country should finance its balance-of-payments deficit at more expensive market rates rather than through a Fund arrangement. This issue should be further discussed when the Board comes to review the Fund's lending instruments.

Mr. Milleron further wondered whether this program should not have been supported by an EFF. I will not surprise you, Mr. Chairman, by expressing the opposite view. Argentina's structural problems are no longer of the "first generation" kind contemplated by the EFF decision. In addition, Argentina has not protracted balance-of-payments needs threatening to prevent it from repurchasing within the normal term.

Mr. Pickford and Mr. Milleron both were of the opinion that this program could probably have become the Fund's first CCL. Today's request confirms my view that by flexibly using the SBA, the Fund can accommodate every worthwhile situation. In consequence, CCLs and SRFs are largely superfluous creatures. Indeed, today's arrangement is a contingent credit line adapted to the needs and merits of Argentina's case.

Mr. Faini observed that Argentina's case does not fit any of the tools in the Fund's toolbox. This observation likewise strengthens my conviction that the more tools we create, the more numerous the gaps between them.

In what I have said so far, I have discussed two ways for Argentina to reduce its financial vulnerabilities: (i) introducing capital controls, which the authorities rightly reject; (ii) contingent credit lines, which indeed today's arrangement provides for Argentina. A third avenue is full dollarization. This is adopting a strong foreign currency as legal tender instead of issuing one's own currency. This road was seriously considered by Argentina last summer. Argentine central bank Governor Pou's intervention at the Boston Federal Reserve Bank's conference last summer was revealing in this connection. I am glad that this idea is no longer being pursued. The costs of dollarization would most likely exceed its benefits.

The program rightly focuses on fiscal consolidation, further strengthening the financial sector, improving the maturity structure of the debt stock, enhancing labor market flexibility, and boosting competitiveness by well targeted investments in ;human and physical capital. I broadly share what my European colleagues have said about the program's content. My main concern is that the implementation timetable is rather slow. My Turkish assistant, sitting here behind me, prepared speaking notes in which he insists that Argentina should have implemented the principal measures as prior actions. Given the design of the Turkish program that the Board considered last December, it is easy to see why he finds this appropriate. But given Argentina's overall good track record, I think we can be somewhat less demanding, although it should be clear that the sooner the measures are taken, the better. The advantage of a slower—or should I say more realistic—pace is that it makes a flawless implementation more likely. And this is what in fact I expect from Argentina.

Mr. Schlitzer said that he agreed with most of Mr. Kiekens's views. Mr. Faini had said that the Board did not have the right tool in the case of Argentina, as the CCL could not be applied and the EFF could not be used in a precautionary fashion. The Stand-By Arrangement was the most appropriate facility, but the SBA had been used to date in far more serious cases, for example during the Asian crisis, and in the case of Turkey. By maintaining an SBA over a long period, the Board would be changing the nature of an SBA. Another solution would be to have a slightly different SBA from what was currently available.

Mr. Pickford agreed with Mr. Schlitzer that the case of Argentina did not require a CCL, although many of the features and conditions that would apply to a CCL were visible in that case. However, there were some essential structural weaknesses both on the fiscal and on the labor market side.

Mr. Ioannou made the following statement:

I want to thank the staff for its excellent report, which was thorough, comprehensive, and well-written. I welcome the inclusion in the report of the sensitivity analysis on the medium-term scenario, which should be emulated in all of the staff reports, especially those related to the use of Fund resources.

I would also like to compliment the new Argentine authorities for the determination that they have exhibited so far and for turning to the Fund for a precautionary SBA. I support the proposed decision.

Argentina's main challenge is to return its economy to a path of sustainable growth, while ensuring that the current account deficit can be financed. The focus on the current account is important because access to international capital markets has, at times, been problematic. The action on the size of the financing requirement, or the current account deficit, and on reorienting the composition of financing, is also important. The current account deficit reflects to a large extent substantial interest payments associated with the country's external debt and much of its trade deficit. The staff is therefore right to focus its attention on the need to reduce external debt. Nevertheless, despite the broad spectrum of measures outlined in the staff report, the external debt as a percentage of GDP is slightly higher in the program period than in 1999. Furthermore, the external debt service begins to decline only in 2002. This outcome may be somewhat unexpected, as this is an important objective of the program, which does look strong on paper. Quantitatively, however, the results seem insufficient to ease financial constraints and reduce the causes of Argentina's difficulties in accessing international financial markets. Looking at the figures closely, it appears that the failure to reduce the external debt in the non-financial private sector exhibits a trend throughout the program period. The staff report notes a number of measures, including those aimed at improving efficiency and promoting private pension funds, intended to increase private saving as a percent of GDP. Yet private saving actually declines over the program period. Could the staff explain why the envisaged program measures failed to lead to an increase in private savings?

As for the effect of the fiscal consolidation on public external debt, I share the view that the size of the fiscal effort could have been stronger. The gains in external, non-financial, private-sector debt are rather marginal, even over the medium term when a number of fiscal reforms are to be implemented.

This again raises some doubts about the effectiveness of the planned reforms. Thus, while the primary balance interest is to rise from the deficit of 0.6 percent in 1999 to a surplus of 3.7 percent in 2002, I do not know to what extent the interest in the surplus is associated with the cyclical upswing of the economy. Could the staff clarify how the structural primary balance evolves over time? Nevertheless, it appears that the fiscal consolidation does not lead to a substantial reduction in the external public debt.

On the efforts to change the composition of external financing, privatization flows are declining over the duration of the program period. Could the staff enlighten us about the prospect of any future privatization in Argentina? It also appears that FDI will exceed in absolute terms the1999 level only in 2002.

Let me point out the importance of prompt implementation of the measures envisaged under the program. Even with the authorities' decision to retain the Currency Board Arrangement, structural reforms are crucial to remove the upward pressure on the exchange rate as well as to improve competitiveness and boost investors' confidence. Without the prompt and decisive implementation of the structural reforms, the overvalued peso could be the target of renewed turmoil. As the results of these measures become evident, prompt implementation is even more important. I would therefore have preferred to have as a benchmark the passage by congress of the relevant details rather than the mere submission to congress of these reform measures.

Ms. Jin made the following statement:

At the outset, I would like to thank staff for their clear and concise report and I also welcome and support the proposed three-year Stand-By Arrangement.

The authorities' strong commitment to the wide-ranging structural reform and stabilization effort, and the Currency Board Arrangement, has contributed to the remarkable improvement in Argentina's economic performance over much of the last decade. Due to the unexpected external shocks in the middle of 1998 which were beyond the authorities' control, macroeconomic performance and the momentum of economic consolidation were, to some extent, weakened. It is noted that the newly sworn in government has launched an immediate set of policy actions and reform initiatives to revitalize fiscal correction and structural reforms in putting the economy back on a sustainable growth path, which, as Mr. Zoccali mentioned in his statement, is essential in the effort to reduce unemployment and poverty and maintain price stability. The authorities are to be commended. In view of Argentina's current economic environment, the authorities' firm commitment to economic consolidation and the large external financing requirement, the precautionary and confidence-building program deserves our support. In general, I concur with the thrust of the staff appraisal and will limit my comments to two issues for emphasis.

Fiscal consolidation is the program's centerpiece and is particularly important under the Currency Board Arrangement. The policy package and reform initiatives envisaged by the authorities have been impressive. The comprehensive and far-reaching fiscal measures, supported by a set of legal and structural changes at both the federal and provincial level, address the fundamental weaknesses on the fiscal front. We fully endorse such a stance. It is noted that the front-loaded fiscal target aims at a significant reduction in the consolidated public sector deficit over the next three years, and over half the reduction (say 2 percent of GDP) will be realized in the course of this year. It is also noted that some contractionary factors associated with the fiscal tightening, along with other elements such as the still unfavorable external environment and foreseeable financing constraints, will dampen domestic demand and, in turn, might undercut the impulse of the fiscal revenue buoyancy. Being alert to the downside risk, the change in the fiscal balance needs to be closely monitored. Any large deviation from the budget may trigger further policy action.

Past experience proves that the Currency Board Arrangement has served Argentina well. In the face of significant competitiveness losses in 1999, the authorities have sought to enhance productivity gains and structural reforms rather than depreciate the exchange rate as they have indicated that depreciation does more harm than good to the economy. I strongly believe that the authorities' approach is absolutely right. In the process of confidence building and arresting uncertain perceptions, the clear message of a stable exchange rate must to be sent to markets.

With these comments, I support the proposed decisions and wish the Argentine authorities further success in their future adjustment endeavors.

Mr. Konan made the following statement:

Despite the adverse external environment, the new government's continued adherence to sound macroeconomic policies and to wide-ranging structural reform has borne fruit, as indicated by the recovery in Argentina and the improvement in employment rates. While complimenting the authorities for these achievements, I share the view that much remains to be done to increase competitiveness and to strengthen market confidence in the economy. I agree with the staff that the precautionary arrangement goes in the right direction and I can support it.

Having said that, I concur with the authorities that the first priority should be given to fiscal policy. In that context, I welcome the envisaged measures requiring a significant additional effort to boost tax revenue, while restraining expenditures. That will improve the federal primary balance. However, as pointed out by Mr. Zoccali in his statement, the federal government's adjustment effort should not be impeded by the provincial government's performance. In this connection, notwithstanding the commendable agreement reached with the provinces on the need to improve finances and the Federal Accord, a more permanent reform of the revenue-sharing scheme needs to be considered at both the federal and provincial government levels.

Moreover, I share the view that the strengthening of the economic reforms underway requires that the authorities improve the solvency of the country, through a stabilization and then a reduction in the public debt-to-GDP ratio. With the improvement of the fiscal deficit, the government debt should decline. Action is also being taken by the government for more active liability management.

On structural reforms, in addition to the wide-ranging measures foreseen in the fiscal sector, the authorities are envisaging commendable measures in the financial sector. These include the text of the central bank charter and the new bill to transform the Banco Nación into a federally owned corporation, which have been submitted to congress.

I welcome the action undertaken to intensify poverty alleviation efforts through the social assistance program. In the same vein, the greater flexibility of the labor market is critical for competitiveness and employment reduction. I therefore welcome the comprehensive reform bill that the new government intends to present to congress and urge the authorities to speed up its passage.

I reiterate my support for the proposed decision, and wish the authorities every success in the future.

Mr. Munthali made the following statement:

We join others in commending the new government for its early action taken to address the root causes of the problems that underlie the recent decline in output and the deep-seated constraints that hamper the attainment of sustainable growth. We are encouraged that these decisive steps include a package of fiscal measures which the congress has already approved. It is also pleasing to note that the authorities have seized the opportunity of its fresh electoral mandate to push through the congress some of the most difficult pieces of legislation, including the labor market reform. Hence, the support by the Fund in the form of a precautionary Stand-By Arrangement will be important in reinforcing the credibility of the authorities' medium-term economic strategy. We therefore have no difficulty in supporting the proposed Stand-By Arrangement for Argentina.

We agree that fiscal consolidation should remain the centerpiece of the program. The successful implementation of the fiscal program will be crucial in securing the medium-term prospects as amply demonstrated by the staff's sensitivity analysis. In this connection, we feel reassured by Mr. Zoccali's lucid statement that the program has been formulated in the medium-term context, placing emphasis on the early restoration of fiscal discipline. Moreover, there is clear sign of ownership, demonstrated by the prospective publication of the memorandum of economic policies on the government's website and the willingness to publish the same documents on the Fund's website. This bodes well for reinforcing market confidence.

The remainder of our comments will be limited to two aspects of the fiscal package, if only for emphasis The design of the fiscal program shows that the authorities have given much thought to early restoration of macroeconomic stability and the creation of conditions for rapid and sustainable growth. In particular, the prospective turnaround of the primary balance is important and has been predicated on a number of actions taken to rein in government spending. We agree that the scope of this effort is wide ranging and carries a contractionary impulse on domestic demand which should be monitored closely as suggested by Mr. Kelkar and others. On balance, however, the spending cuts on wages, the purchase of goods and services, social security benefits and other entitlements will be necessary in order to re-establish fiscal discipline at an early stage. In the event, we commend the careful front-loading of the deficit at the federal level while back-loading ceilings on primary expenditure, taking into account the timing of the tax measures. While some safety margin have been built into the expenditure ceilings, the achievement of the deficit target could be buttressed by contingency measures that could be implemented quickly. This may be important in light of the downside risks cited by the staff and stressed by Mr. Bernes and others. We wonder if the authorities and the staff have discussed any possible contingency measures.

Another critical element of the program is the resuscitation of the reform agenda that will be important in underpinning improvements in efficiency. Since many have stressed the key areas of concern, we would only highlight those which have been designed to improve the cost effectiveness of government spending, especially in the area of social assistance programs. We would encourage the authorities to eliminate duplication for which efforts are being made under the direction of the vice president's office to identify overlapping programs. With the intention to better coordinate efforts with the local governments and communities, we would hope that the delivery of services will be significantly streamlined, while broadening the involvement of local groups, including NGOs.

Finally, we believe that the Currency Board Arrangement has worked well for the authorities since its adoption in 1991 and has helped to in instill discipline and served as a credible anchor for macroeconomic policies. We also agree with the authorities' strategy of seeking to improve competitiveness through the implementation of wide ranging structural reforms, including in particular labor reforms that could foster wage moderation.

With these brief remarks we reiterate our support for the proposed decision and wish the authorities success with their adjustment program.

Mr. Donecker made the following statement:

We support the proposed decision, and see the same risk in the program design and need for action as other Directors have noted. Nevertheless, I support what Mr. Schaad said about the exchange-rate regime and the idea that implementation of the right policies will be the decisive catalyst. Let me make a few comments.

The new government is strengthening the macroeconomic policy, especially the consolidation of public finances. While we broadly concur with that strategy, we are concerned that the strengthening on the revenue side is to be mainly achieved by an increase in taxes. Although we welcome the structural measures to reduce the scope for tax evasion and to broaden the tax base, we would have preferred to see such measures in place as a first step The tax package will heighten the tax burden and hamper the growth of private demand.

I want to underline once again the need to ensure that the labor market enjoys the maximum level of flexibility in the framework of the Currency Board Arrangement. Argentina is participating in the rise of the dollar, with all of the positive and negative economic effects that that entails, in particular with regard to international competitiveness. However, the abandonment of the current exchange-rate regime is not a viable option, particularly given the large amount of foreign exchange denominated debt. Total external debt in 1999 reached more than five times the amount of exports, one of the highest ratios in South America.

Against this background, it is understandable that the authorities, supported by the staff, have chosen the strategy of improving the external position by strengthening competitiveness and increasing domestic savings. However, we should be aware that the envisaged structural reforms, especially in the labor market, as urgent as they are, will need time to improve the competitiveness of the economy.

The authorities are challenged to perform a difficult balancing act, and we wish them much success.

Mr. Kioa made the following statement:

At the outset, I would like to congratulate the management and staff for successfully completing negotiations with the Argentine authorities and thank the staff for the well-balanced reports. I also would like to thank Mr. Zoccali for a very comprehensive statement.

The Argentine economy has shown signs of some turn-around from the sharp contraction in 1998 and 1999 to a nascent recovery. Industrial production has picked up, exports have surged and consumption has shown a moderate increase. External environment, such as the Brazilian economy, low export commodity prices and the tighter access to the international capital market, which partly led the country into a recession, has improved and helped create a better environment for the country. On the political side, the presidential election was concluded with great success that created a further momentum for the recovery. The new administration has committed to creating conditions for sustainable recovery and seized the opportunity to move the economy forward by initiating some measures. The authorities deserves to be commended for their management of the economy.

The request for a Stand-by Arrangement by the Argentine authorities is based on a strong program design. The authorities believe that a firm implementation of the policies outlined in the program will boost confidence both at home and abroad. Improvement of confidence from the international community will play a significant role in opening up the market access for the country. This will crucially help enhance the financing strategy of the Government as well as reduce the current relatively high cost of financing. At the same time, international confidence is also crucial in helping open the access of the Argentine exports which will improve the trade balance. Therefore, the successful implementation of the program will provide a solid foundation for further strengthening the recovery. This confidence is reflected in the output projections, in which the program conservatively forecast a GDP growth of 3.5 percent, while the Government is confident in achieving growth of 4 percent in 2000. Therefore, we welcome the new three-year Stand-By Arrangement for Argentina and support the proposed decision.

I concur with the general thrust of the staff appraisal and will only make some brief comments on a few points.

Fiscal consolidation and reform is the crucial element of the program in a context of the Currency Board Arrangement. Therefore, the most important task is to quickly rectify the fiscal slippages in 1999. In this respect, we are encouraged by the recent positive developments. The new administration has made a great deal of progress in the fiscal front by getting early approval on the budget and fiscal package as well as on the Fiscal Responsibility Law. While we can argue whether fiscal tightening is appropriate at this stage of recovery, the need to gain confidence by sending a right message is also equally important. Therefore, the contractionary impulse of around 1.7 percent of GDP in 2000 constitutes a fine balance between the two objectives.

The current exchange rate regime has served Argentina well. This regime has become an anchor for the Argentine economy in the 1990s and has played a crucial role in producing high growth rates and subdued inflation. However, their high external financing requirements clearly constitutes a risk for the long-term sustainability of the regime. Therefore, to increase its sustainability, further implementation of macroeconomic policies and structural policies is necessary. Serious efforts are needed to increase the savings rate, especially by the public sector through the fiscal consolidation and reform efforts, and thus to bring down the level of the current account deficit.

What we find to be remarkable is the degree of soundness in the financial system. At the time of a crisis, there were various shocks to the Argentine financial system. Yet, the financial system has stayed intact and could well maintain their level of soundness. The authorities determination not to deviate from the current exchange rate regime under a very severe pressure in their foreign exchange market has certainly helped avoid putting exchange rate risks to their banking system. However, the fluctuation on the interest rates and the deteriorating economic environment have certainly caused some impact to the banking system. The fact that the banking system could weather well the crisis and could maintain their level of soundness is certainly something to be commended.

The reports indicated that the authorities intend to treat the arrangement as precautionary. Since in the current policy the Argentine authorities are relying their financing sources primarily on the capital market, the need to have some contingent financing sources become paramount. Reading the report, I got the impression that the authorities seems to intend to accumulate undrawn balances under a Fund arrangement, so that when the capital market line is interrupted, the authorities could resort to the undrawn balances. Staff also indicated that the availability of substantial Fund support through this facility should help convince the market and hence the continuing market access for Argentina. Thus, the arrangement is basically what is designed for the Contingent Credit Line.

Since the facility that will be granted to Argentina is a precautionary SBA and not CCL, I welcome the staff's clarification as to the size of the maximum undrawn balances that can be withdrawn by the authorities compared with CCL. I also would like to hear their explanation on the comparative advantage for the country to use this facility instead of the CCL. The answer might help the Board in assessing the usefulness of the CCL and further improvement of the facility.

With these remarks, we wish the Argentine authorities further success in their future endeavor.

The Deputy Director of the Western Hemisphere Department said that there were clearly downside risks in the growth outlook for 2000, in particular relating to the impact of the fiscal package on consumption. Nevertheless, the staff felt that given that the conjunction of indicators in place or assumed in the program, a rate of about 3.5 percent was achievable. The authorities were more optimistic, but the staff felt that it would be prudent to predicate the projections for the fiscal accounts on lower growth prospects. The staff had discussed contingency measures with the authorities, should revenues be affected by a less-favorable-than-expected growth performance. Those contingency measures were related to spending, as it was not possible in the short run to count on additional tax increases. The improvements in tax administration that the authorities were pursuing with vigor could also not be expected to produce results in the short run.

The authorities had had a quarterly system of allocating of spending appropriated amounts in the budget, and that was being revised to a monthly schedule to take into account the revenue performance in previous months, the Deputy Director reported. The staff had month-by-month projections, and any deviation from that in revenues was to be followed by prompt reductions in authorized spending.

Oil prices in Argentina had been completely liberalized, and the price of domestic gasoline prices and other oil products had been rising, the Deputy Director noted. However, the impact of the increases on the Consumer Prices Index (CPI) had been quite limited to date. The CPI had risen by 0.8 percent in January, reflecting other excise tax increases, but it was zero in February, at which time any substantial impact from oil should probably have been evident. The relatively subdued pace of expansion of the economy and the slack in the labor market had contributed to dampening of inflationary pressures.

The projection that the external debt would increase as a percentage of GDP during the program period was a reflection of prudent estimates relating to the current account, the Deputy Director explained. The staff was relatively conservative in its assumptions, both about export performance and import growth during the program period. However, in the medium-term projections, the debt was expected to decline significantly in relation to exports.

On why private savings were projected to initially fall in the program period, the staff wanted to take into consideration the fact that the private savings ratio in 1999 had increased somewhat, reflecting cyclical developments, the Deputy Director explained. There were uncertainties related to the overall international environment and the electoral process, which in Argentina tended to moderate consumption. Perhaps the staff would be favorably surprised in that respect, but again it preferred to be on the pessimistic side and to consider the fact that there might be some offset of the increase in public savings through a partial decline in private savings.

Regarding Mr. Donecker's comment that he would have preferred to have seen more emphasis on changes in tax administration, the authorities would also have preferred such measures to the unpopular changes in tax rates, the Deputy Director remarked. The government was making improvements in tax administration a priority; many measures had been put in place and laws introduced in congress to create a legal basis for reforms, as detailed in the staff report. However, it would not be prudent to rely on those measures to produce the desired effect in the first year of the program. If they did not produce the desired effect by the second year of the program, it would be difficult to meet the revenue targets for the following year.

The availability of the purchase was covered in Table 14 of the staff report, which showed the outstanding use of Fund resources as a percentage of quota, if the arrangement were to be drawn upon any particular point in time, the Deputy Director indicated.

The staff representative from the Policy Development and Review Department noted, in relation to the balance-of-payments needs, that Argentina had large amounts of gross borrowing and a significant need for debt maturing.

In response to Mr. Schlitzer's point about the applicability of the SBA, such arrangements had been negotiated since the 1970s, so it was not a particularly new instrument, the staff representative said.

Mr. Zoccali made the following concluding statement:

I recognize that it has been a long Board day and that there is more yet to come, so that I will keep my comments short.

With your permission I will address first the question raised by Ms. Lissakers regarding my authorities' intention on publication of the Letter of Intent.

Perhaps I should return to the issue of publication which was raised by Ms. Lissakers. My authorities have been making significant efforts to enhance the transparency of their policies, and have recently gone as far as posting on the government's website the results of individual procurements with private suppliers. In consonance with the presumption agreed by the Executive Board on publication of Letters of Intent, they have also posted in their website, as I noted in my buff, the memorandum of economic policies, together with the quantitative performance criteria table and the technical memorandum of understanding in full in both Spanish and English.

In keeping with past practice, they have not included the summary structural benchmark table which appears as Annex II. The reasons are straightforward, the summary provides no additional information regarding the structural benchmarks that are fully expounded upon in the Memorandum of Economic Policies, except a specific indication of sequencing. Most significantly, it is the opinion of my authorities, who have the responsibility for working with the Congress, that the nature of the table may be interpreted as an imposition from outside not only on the type of measures but on the timing for action binding a sovereign Congress. This would, in their view, weaken rather than strengthen ownership over structural reform measures and may also affect the readiness of Congress to act, disregarding the fact that it has generally been supportive when it comes to substantive legislation to underpin stability.

Moreover, my authorities did not use the opportunity to request confidential treatment of this information, because they considered that the Board should be fully apprised of all aspects bearing on the program from the outset.

Finally, on this issue, it was not discussed during the actual program negotiations. I trust, therefore, that the Board will afford my authorities' the minimal leeway to exclude the Annex II summary table, which in no way compromises the quality of the information regarding their policy the same information be disseminated in the Fund's website undertakings, from dissemination in the Fund's website.

Having addressed this issue, I wish to thank my colleagues for their permanent interest in Argentina, as evidenced by the eight grays and the thoughtful observations voiced this afternoon. Additionally, I would be remiss if I didn't express a special word of appreciation to the staff mission, and of course the Chairman, for the tireless work and high quality of the advise offered which makes Argentina's relationship with the Fund particularly useful.

In light of the completeness of staff's replies, allow me to pick out just a few salient issues of the many important observations made.

First, my authorities agree entirely that the opportunities need to be taken advantage of , to reduce procyclical fiscal tendencies and structural sources vulnerability. In this regard, they have prioritized fiscal order to give a clear signal regarding the importance attached to inter-temporal fiscal solvency even when this means pushing through a tax package at a time when the economy is recovering. The president is absolutely committed to fiscal responsibility and to supporting the fastest possible fiscal consolidation as a key priority of his administration.

The need to avoid withdrawing fiscal stimulus abruptly when the recovery remains weak was noted in the statements of Messrs. Portugal, Pickford and Kelkar, and represents a concern that is being balanced against the importance of early reestablishment of confidence. The recent response of capital markets to these developments have been encouraging and should be seen, together with the 16 percent growth of exports, mostly in terms of volume, as leading indicators of improving sentiment for investment and consumption and GDP growth in the 3.5/4.0 percent range. In the first 10 days of March alone, Argentina has been able to place the equivalent of around US$ 1.5 billion in medium and long term securities in US dollars and Euros, at a declining risk-premium of between 230 and 320 over equivalent issues since last August. Since the beginning of the year, it has raised some US$ 4.6 billion in medium-and long term bond issues in international capital markets (over 50 percent of scheduled global bond issues) at an average coupon of 10.9 percent and an average maturity of 11.8 years, evidencing the priority placed on ensuring an adequate maturity profile despite the higher costs involved. The latest 500 million Euro issue placed yesterday with a final maturity of 4.5 years was priced at a spread over equivalent Treasuries of 384 basis points. The recent debt exchange of over US$ 3 billion, reduced the financing requirement in 2000 by US$ 0.7 billion and public sector amortizations through 2002 by US$ 2.2 billion, it also lengthened the average maturity of the exchanged debt by 1.9 years and constitutes an example of Argentina's ability to take advantage of market opportunities and work closely with market participants. All of this has undoubtedly also been helped by the statements of official support for its economic policy and prospects.

Turning to the catalytic effects of a significant precautionary official support package for Argentina raised by Mr. Bernes and other Directors, we should keep in mind that integrated financial markets have tended to lump together endogenous and exogenous events when assessing emerging country-risk vulnerabilities. In this regard, the consistent Argentine policy response, tied to a predictable and understood economic policy-framework, can be said to have helped to mitigate not only the domestic consequences of uncertainty and contagion but, as significantly, the likely prospect of wider regional disturbances, following the succession of external shocks since the mid 1990s, that was well described by Mr. Carstens, including historically low commodity prices compounded by the income depressing impact of subsidized agricultural production in advanced economies and difficulties in accessing their markets.

The Fund's contribution to enhancing the quality and consistency of the economic policy mix is incontrovertible and the cost-effectiveness of the precautionary approach during turbulent times has been clearly established: Fund exposure in Argentina has declined steadily since early 1998, by some 1.8 billion DR to less than 150 percent of quota. The fact that IF support is conditional on sustained good performance, underpinned by my authorities ownership and firm policy commitment going forward, reduces the risk of a "rush for the exits" to borrow the term of Mr. Bernes. More generally, the discussion of Fund facilities seems to be the best opportunity for reviewing the merits of existing instruments, including the CCL, to provide confidence to members in the circumstances of globalization.

Of course, even the firmest commitment to reforms could be insufficient to preclude an increased perception of vulnerability arising from an unexpected adverse external disturbance. The odds are that any significant event of this type would affect not only Argentina. This points to the need for effective multilateral surveillance as well as for precautionary official support to owned efforts of reform to sustain the momentum of adjustment despite the recurrence of adverse shocks. The fact that Argentina has been able to deliver price stability and growth without resorting to capital or exchange controls and keep domestic markets relatively free, and enhance the soundness of its financial sector with almost no fiscal cost, attests to the effectiveness of the strategy of precautionary but conditional official support for Argentina and, more generally, the region.

More specifically on the plans for Banco de la Nación, mentioned in the context of pending reforms impinging on financial sector development, I should reaffirm that my authorities are committed to increasing the transparency of its operations while ensuring that it meets the strict prudential and supervisory standards being applied to private banking institutions and protects its profitability. Legislation has been prepared and will be submitted to allow its transformation into a state-owned corporation to enhance management efficiency, market-discipline and transparency over the operations of the institution. In a still segmented domestic credit market, my authorities consider that Banco de la Nación can play a useful role to help improve access to credit by small and medium enterprises and agricultural producers, particularly affected by crowding out in periods of financial stringency, and more generally, by still significant information asymmetries and in some provinces, where BNA is the largest supplier of credit, outmoded legal frameworks that constrain financial intermediation. They remain committed to enhancing market based management and credit allocation practices at BNA, paving the way for the continued development of the financial system.

With these comments, Mr. Chairman, allow me to reiterate my appreciation to the Executive Board for its expressions of continued support and assure my colleagues that their constructive remarks will be faithfully conveyed to my Argentine authorities.

The Acting Chairman asked the staff to comment on Argentina's position regarding the issue of the non-publication of Annex 2.

The staff representative from the Policy Development and Review Department indicated that the decision of June 3, 1999 provided that in the case of requests relating to an arrangement, it would be the presumption that the LOIs, memoranda, and, where appropriate, PFPs, would be published, including on the Fund website, shortly after the Board discussion. If a particular country did not want to publish the documents, the basis for that decision would have to be presented to the Executive Board. Nothing in that decision excluded the possibility of omitting certain elements of the documentation. Since then, the Board had tried to maintain the principle of the integrality of the publication of relevant documentation, including in the cases of Mexico, Brazil, Portugal, the Philippines, and a few other countries.

Market sensitivity had been the motivation being requesting the omission of some information on banking system reforms in the case of Mexico, the staff representative continued. In the end there was no Fund publication of Mexico's LOI, but the authorities voluntarily published the LOI on the country's own website. In the case of the Philippines, the authorities had also judged that the information pertinent to the performance criteria on the net international reserves was market-sensitive. As the majority of Executive Directors was unpersuaded by those arguments, and Mr. Taylor had withdrawn the request on behalf of the authorities. In the case of Brazil there had been an agreement that all of the documentation would be published.

In the case of Argentina there was no concern about market sensitivity, but more a question as to how much the government could undertake on behalf of its legislature, the staff representative continued. Whereas the policy undertakings were precisely described in the pertinent paragraphs of the memorandum of economic policy, Annex 2 elaborated on four or five of the 11 undertakings that would be carried out implicitly by congress by given dates. That might be a legitimate cause of difficulty for the Argentine authorities. The staff had sympathy for the predicament of Mr. Zoccali and the authorities, but did not want to prejudge the views of the Executive Directors. That was the first time that that particular issue of political sensitivity had arisen.

Ms. Lissakers agreed that implicit in the presentation and timeline in Annex 2 was the presumption that the legislature would have acted, which might be slightly uncomfortable. Mr. Zoccali had said that the substance of Annex 2 was already covered in the other documents that would be made public. There was thus no problem with the Argentine decision not to publish Annex 2.

The Acting Chairman observed that Directors had indicated support for Ms. Lissakers's position.

Mr. Faini recalled that the Board had had a discussion on whether it should request countries to submit important measures to parliament or request in an arrangement that measure be approved by parliament. However, that issue raised some delicate political issues, and in that sense he was comfortable with Argentina's request.

Ms. Lissakers said she hoped that in the future it would be made clear to the Board in advance that there was an intention not to publish some element of the documentation. When there was a general statement that the LOI would be published, Directors assumed that that applied to all parts of the LOI. It was incumbent on the staff and the relevant Director to be clear about what the publication intention was, including any exceptions.

The Acting Chairman made the following summing up:

> Executive Directors endorsed the Argentine authorities' request for a new Stand-By Arrangement. They welcomed the strong and well-balanced economic program the authorities had proposed, and, in particular, that the new government had already moved quickly and effectively to put in place many of the fiscal measures envisaged under the program, and that it had submitted the labor legislation to the congress. They considered that these measures, together with other structural reforms foreseen in the program, will buttress confidence in domestic and foreign financial markets and facilitate a sustainable recovery of the economy, with continued price stability. They regarded this program as deserving Fund support and noted the authorities' intention to treat the arrangement as precautionary.
>
> Directors emphasized the importance of reversing the increasing trend of the public debt, while addressing in a comprehensive manner the burden of

past government liabilities. They considered that the fiscal targets for 2000 and beyond were achievable, but pointed to the need to maintain a firm control on spending, and to continue efforts to broaden the tax base and improve compliance. They emphasized the need to execute the program fully, and noted that the authorities should be prepared to enact further spending cuts should revenue performance be weaker than projected.

Directors encouraged the authorities to move forward with their program of structural fiscal reforms, which are essential to secure a lasting improvement in public sector finances, as well as to improve the equity and efficiency of both taxation and public spending. In particular, they stressed the importance of speedy implementation of the changes proposed in the areas of tax administration and public expenditure management, which will result in improved governance and transparency, and will help offset any adverse consequences of the recent easing of payment terms for tax arrears on compliance over the medium term. Directors noted that further reforms of the social security system are needed to ensure the system's long-term solvency.

Directors emphasized the need for early progress toward a more permanent reform of the revenue-sharing arrangement with the provinces. They noted that the provinces remain a source of risk in the program. In this regard, they welcomed the incorporation of the provinces in a binding ceiling on the consolidated public sector debt at end-2000, and stressed that, to ensure compliance with this ceiling, the authorities will need to use all instruments of control over the provinces' indebtedness available under the existing legal framework.

Directors noted that the proposed labor market legislation, if passed without significant modifications, would go a long way toward reducing existing labor market rigidities. This reform, together with measures to increase competition and foster efficiency in the services and utilities sector, will contribute to moderating labor costs and improving the competitiveness of the economy, as well as to enhancing the economy's ability to absorb external shocks. Directors stressed that early progress in this area could help broaden the national consensus on further necessary labor reforms. Some Directors emphasized that further opening up of the economy will, in conjunction with domestic deregulation, help promote the competitiveness of the economy and foster employment creation.

Directors noted that reforms of the financial system in recent years have strengthened its soundness and its resilience to external shocks. They encouraged the authorities to continue modernizing and better coordinating the regulatory frameworks for bank and non-bank financial intermediaries, in line with best international practices. They stressed that the authorities should not attempt to influence the allocation of credit, and should especially avoid using financial institutions to support specific sectors or categories of enterprises. They also underscored the importance of transforming Banco Nación into a federally-owned corporation with a view to increasing the transparency and efficiency of the bank's operations.

Directors noted that reflecting substantial scheduled debt amortizations, external financing requirements would remain large in 2000 and beyond, even as the current account improves. They considered that these requirements should be manageable, provided confidence is buttressed by an improvement in external trade performance and by a determined implementation of the announced economic program. Directors emphasized that the needed improvement in the external accounts will have to be sought through a combination of measures to increase public and private savings and to strengthen competitiveness. Directors noted that the currency board framework under which Argentina operates has served the economy well, making it important to continue increasing the flexibility of the economy.

The Executive Board took the following decision:

1 The government of Argentina has requested a Stand-By Arrangement for a period of three years in an amount equivalent to SDR 5,398.61 million.

2. The Fund approves the Stand-By Arrangement set forth in EBS/00/20, Supplement 3.

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

4. The Fund notes the cancellation of the Extended Arrangement for Argentina approved on February 4, 1998 (EBS/00/20, Sup. 1, Cor. 1, 3/10/00).

Decision No. 12156-(00/24), adopted
March 10, 2000

3. RELATIONS WITH WORLD TRADE ORGANIZATION—INVITATION TO ATTEND EXECUTIVE BOARD MEETINGS

The Executive Directors agreed to invite the Secretariat of the World Trade Organization to send an observer to attend the upcoming discussions on the world economic outlook, tentatively scheduled for Wednesday, March 22, and Friday, March 24, as well as the discussion on trade policy for development and poverty reduction to be taken up by the Committee of the Whole for the Development Committee on Friday, March 24.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/00/23 (3/8/00) and EBM/00/24 (3/10/00).

4. METHOD OF COLLECTING EXCHANGE RATES FOR CALCULATION OF VALUE OF SDR FOR PURPOSES OF RULE O-2(a)

Effective March 9, 2000, Decision No. 6709-(80/189) S, adopted December 19, 1980, shall be amended as follows:

"Paragraph 2 shall be amended by replacing the reference to "buying and selling rates at the fixing in the Frankfurt exchange market communicated by the Deutsche Bundesbank" with the following: "euro reference rates of the European System of Central Banks communicated by the European Central Bank"." (EBS/00/38, 3/2/00)

Decision No. 12157-(00/24) S, adopted
March 9, 2000

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by Advisors to Executive Directors, and by an Assistant to Executive Director as set forth in EBAM/00/35 (3/7/00) is approved.

APPROVAL: June 8, 2001

SHAILENDRA J. ANJARIA
Secretary