August 30, 2001
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 00/117

10:00 a.m., November 29, 2000

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

S. Fischer, Acting Chairman
E. Aninat, Acting Chairman
S. Sugisaki, Acting Chairman

Executive Directors	Alternate Executive Directors
S.M. Al-Turki	A.S. Alosaimi
A. Barro Chambrier	D. Ondo Mañe
T.A. Bernes	P. Charleton
	P.R. Fenton, Temporary
M.J. Callaghan	I.-K. Cho, Temporary
	P.H. Whitehall, Temporary
R.F. Cippà	W. Szczuka
	B. Siegenthaler, Temporary
	F. Zurbrügg, Temporary
	D.H. Kranen, Temporary
	C.-P. Schollmeier, Temporary
	R. von Kleist, Temporary
R. Faini	H. Vittas
	C.A.E. Sdralevich, Temporary
K.-T. Hetrakul	Sugeng, Temporary
V.L. Kelkar	R.A. Jayatissa
	J. Prader
	J. Jonáš, Temporary
O.-P. Lehmussaari	Å. Törnqvist
	I. Steinbuka, Temporary
K. Lissakers	M. Lundsager, Temporary
	E.S. Weisman, Temporary
J.-C. Milleron	G. Bauche
	S. Le Gal, Temporary
A. Mirakhor	
A.V. Mozhin	A. Lushin
	J.R. Suárez, Temporary
S. Pickford	S.P. Collins
	H. Hagan, Temporary
	R. Junguito
C.D.R. Rustomjee	
A.S. Shaalan	
Wei Benhua	Jin Qi
	Xu J., Temporary
J. de Beaufort Wijnholds	Y.G. Yakusha
Y. Yoshimura	H. Toyama
	G.R. Le Fort
	O.A. Hendrick, Temporary

S.J. Anjaria, Secretary
A.S. Linde, Acting Secretary
A. Mountford, Acting Secretary
Z. R. Ahmed, Assistant
C. Andersen, Assistant
R. Gudmundsson, Assistant

Also Present

IBRD: E. Jorgensen, C. Ruehl, Europe and Central Asia Regional Office; M. Peñalver, South Asia Regional Office; I. Haque, Office of Executive Director. Asia and Pacific Department: Y. Horiguchi, Director; A. Singh, Deputy Director; W.S. Tseng, Deputy Director; R. Moghadam, S. Schwartz. European I Department: S.M. Schadler, Deputy Director; B. Banerjee, M. Cihak, S.M. Darbar, T. Wang, J.F. Zalduendo, E.J. Zervoudakis. External Relations Department: C. Lotze, V.N. Shastry, J. Starrels. Fiscal Affairs Department: G.T. Abed, W.A. Allen, C.A. Klingen, D.K. Moore, G. Taube. IMF Institute: M. Khan, Director. Legal Department: N.S. Kyriakos-Saad, R.B. Leckow, M.B. Luedersen, N.Y. Rendak, B. Steinki, R.L. Weeks. Middle Eastern Department: P. Chabrier, Director; D. Burton, Deputy Director; P. Dhonte, Deputy Director; A.M. Carare, S. Eken, K. Enders, A.C.A.R. Furtado, F. Hameed, T.F. Helbling, A.M. Husain, M.M. Lazare, J. Le Dem, K. Nashashibi, G. Shabsigh, J. Toujas-Bernate. Monetary and Exchange Affairs Department: O.M.J. Frecaut, P.L.C. Hilbers, M.A. Josefsson. Policy Development and Review Department: C. Brachet, W. Brown, M.J. Fetherston, U. Jacoby, R. Kincaid, A.A.F. Op de Beke, M. Ronci. Research Department: A. Spilimbergo. Secretary's Department: S. Bhatia, T. Turner-Huggins, O. Vongthieres. Statistics Department: P. Cotterell. Treasurer's Department: E. Brau, Treasurer; A.B. Westphal. Office of the Managing Director: D.A. Citrin, S. Tiwari, R. Munoz Carmona. Advisors to Executive Directors: J.M. Abbott, M.A. Ahmed, E. Azoulay, M.P. Bhatta, J.A. Chelsky, J.A. Costa, I. Dragulin, S.S. Farid, A. Fidjestøl, O. Himani, E.J.P. Houtman, J.M. Jones, I. Mateos y Lago, M.F. Melhem, H. Morí, S. Rouai, G. Schlitzer, M.R. Shojaeddini, S. Thiam, I.M. Woolford, M. Yanase. Assistants to Executive Directors: A.S. Al Azzaz, V. Bashkar, J.G. Borpujari, P.A. Brukoff, N. Burnashev, G.M. Campos, V. Dhanpaul, E. González-Sánchez, N. Guetat, T. Hadded, M.S. Hililan, S. Hinata, A. Jacoby, S.K. Keshava, T. Koranchelian, E. Kornitch, K. Kpetigo, J.K. Kwakye, Liu Z., A. Maciá, R. Maino, R. Manivat, J.A.K. Munthali, G. Nadali-Ataabadi, K. Ongley, Y. Saito, T. Skurzewski, D. Taylor, S. Vtyurina, D.B. Waluyo, I. Zakharchenkov.

1. ROMANIA—2000 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 2000 Article IV consultation with Romania (SM/00/249, 11/3/00), together with a background paper on selected issues and a statistical appendix (SM/00/250, 11/6/00).

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

> This statement provides information on recent political and economic developments in Romania that has become available since the circulation of the staff report and selected economic issues paper for the 2000 Article IV consultation (SM/00/249 and SM/00/250). New developments do not change the thrust of the staff appraisal.
>
> Early results indicate that the parliamentary elections of November 26 returned former President Iliescu's left wing PDSR party to power, but short of an absolute majority, with the nationalist Greater Romania Party recording a strong second-place finish. The parties of the current center-right coalition government suffered considerable losses. Leading PDSR politicians have announced that they will seek to form a coalition with parties of the current governing coalition. The parliamentary election outcome was mirrored in the presidential polls, in which Mr. Iliescu received the largest share of the votes but fell short of an absolute majority, so that he will face a runoff election against the nationalist party leader, Mr. Tudor, on December 10.
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> On November 9, the European Commission made public its assessment of Romania's progress toward meeting the Copenhagen accession criteria. The report states that "Romania cannot be regarded as a functioning market economy and is not able to cope with competitive pressure and market forces within the Union in the medium term" and that Romania "has not substantially improved its future economic prospects". The assessment was also critical with respect to governance issues and a lack of progress in structural reform.
>
> Recent economic data broadly confirm the picture described in the issued documentation. Preliminary data indicate that the monetary and fiscal policy stance through end-September remained appropriate, while slippages in domestic arrears and wage policy became more pronounced. Accordingly, all end-September performance criteria were met, except those regarding the public sector wage bill and domestic arrears reduction, which were missed by significant margins. Since, then, however, there has been evidence that the underlying risks to fiscal policy have materialized and that backtracking has occurred in the area of structural reform.
>
> Inflation has continued at relatively high levels and reached a 12-month rate of 42.9 percent in October, consistent with an end-December staff projection of 40 percent. This is largely the result of continuing slippages in

reducing domestic arrears and limiting public sector wage growth, mainly as a result of a failure to implement key legislation.

Reflecting continued buoyant export performance, the current account deficit reached 1.6 percent of GDP at end-September. In November, the authorities were able to tap international capital markets again with a €150 million issue with a 5-year maturity and an interest rate of 11.6 percent. The external performance was reflected in an increase in the National Bank's net foreign assets to US$1.7 billion at mid-November, in line with the end-December performance criterion.

Preliminary data for September indicate that fiscal policy has remained tight, with a recorded deficit of 2.2 percent of annual GDP. Since then, however, the authorities announced—and subsequently started to implement—a number of nonbudgeted policy initiatives (inter alia, relating to additional expenditure on hospitals, child allowances, pensions, household heating subsidies, agricultural and mining subsidies as well as a tax amnesty, which taken together would add some ¾ of one percentage point of GDP to the deficit in 2000. In addition, the underlying imbalance of the pension system has been aggravated through higher spending, lower revenue, and announced cuts in contribution rates as of December 1.

The authorities also backtracked on their commitment to liquidate Banca Agricola if privatization efforts were to fail. Instead, they decided to recapitalize the bank, at a cost of lei 4.6 trillion (US$185 million), with a view to keeping it in operation indefinitely.

The banking system has witnessed a renewed test of confidence, as a foreign-owned bank has not been able to meet requests for withdrawals. The NBR has instituted special surveillance and uncovered fraudulent practices.

Mr. Wijnholds made the following statement:

The present consultation covers two years that can be characterized as a synthesis of the whole 11-year transition process in Romania. On the one side, the first year started with an unenviable portfolio of unresolved economic issues, most prominently a critical external position. On the other side – partially reflecting the pressure of events -, the Romanian authorities have adopted a much more realistic policy response. The staff report presents accurately the change of course in the policy setting. In the Romanian authorities' opinion, the report is a convincing analysis, drawing balanced conclusions. They also appreciate the useful integration of the analysis both within a temporal framework (connected to the whole transition process in Romania, and in a medium-term perspective) and a regional one. The additional information in the Selected Issues paper is equally welcome.

Macroeconomic developments and policies have generally improved during 1999-2000. However, in the run-up to the elections (held on November 26, 2000), policy firmness tended to erode somewhat (also explaining the inability to conclude the second review of the Stand-By Arrangement). The first qualification that could be made is that, confronted with growing liquidity concerns that had emerged in late 1998 and early 1999, the authorities reacted with corrective policies, including a flexible exchange rate (that moved to a new equilibrium level) and firm fiscal and monetary policies. As a result, a large adjustment of the current account position took place, bringing the deficit to a more sustainable level (3.9 percent of GDP in 1999 and, estimated, marginally higher in 2000). In parallel, reserves have been built up gradually. The second comment is that other policies have been utilized to support the stabilization effort, including incomes policy and some important structural reforms. The primary fiscal deficit shrank substantially in 1999, turning into a surplus. The decline in economic activity (GDP went further down in 1999) has been arrested and reversed in 2000. Inflation, however, remained high, reflecting mainly currency depreciation (especially in 1999) and persistent weak financial discipline in the enterprise sector.

The Romanian authorities consider that their efforts have succeeded to place the economy at the end of the year and their mandate, on a more sustainable foundation, with improved macroeconomic balances and viable policies. This is also borne out by the two credits obtained in September and November 2000 on the private capital markets, totaling EUR 300 million. The authorities had to act in a difficult political and social context and strove to press ahead with their program as much as possible.

The authorities agree with the staff that the evident progress in policy implementation in Romania should necessarily be placed in the context of long-term sustainability and strategic objectives of the country, in particular its integration into the European Union. From this perspective a few prominent tasks loom ahead of the authorities. First, the need to reduce inflation. This will require adding to prudent financial policies stronger support on the part of incomes policies and financial discipline. Second, a continuation of efforts toward fiscal consolidation, with expenditure prioritization and pension system reform as the main challenges. Third, a decisive drive to move forward with bank privatization/restructuring and strengthening of bank regulation and supervision. Finally, the need to complete the process of enterprise privatization. The remainder of my statement deals with these issues.

The Romanian authorities fully concur with the staff on the causes of persistent high inflation in Romania. Several programs—supported by Fund Stand-By Arrangements—attempted to rein in the inflationary process over the past decade. In actuality, given the limited progress in implementing structural reforms, each time inflation remained to be dealt with based on tighter monetary and—at times—fiscal policies. The results were modest and short-lived. Moreover, adverse side effects proved more prominent, such as a proliferation of payments arrears, high real interest rates and crowding-out of the private sector from bank credit. In recent years inflation reflected the combined effect of tighter monetary and fiscal policies on the one side and, on the other side, steeper depreciation of the domestic currency, increased enterprise arrears and—particularly in the current year—the impact of exogenous adverse shocks (higher oil prices and drought). There is now abundant evidence that a lasting success in disinflation in Romania can only be achieved by supplementing monetary policy with greater support from incomes and fiscal policies, and by a substantial improvement in financial discipline in the enterprise sector. While the authorities have made efforts to deliver such consistent policies in 2000, the political difficulties contributed to continuing problems in the area of wages and arrears.

Fiscal policy has been subject to significant improvements since 1999. It has succeeded to play a greater role in the stabilization effort and, at the same time, it underwent a notable structural overhaul. Indeed, the primary balance improved in 1999 by 3 percentage points of GDP, turning into a surplus; a surplus is also projected for the current year (even if smaller than envisaged in the Stand-By Arrangement). As to the overall deficit in 2000, the staff's estimates stand at 4.3 percent of GDP (against 3.8 percent last year), while the authorities project a figure close to the program (3.5 percent of GDP). The year 2000 has witnessed important, politically sensitive reforms, particularly on the revenue side. All previous tax-holiday and investment-incentive legislation was abrogated and the statutory company income tax rate lowered from 38 percent to 25 percent. Similarly, a new law introduced a global income tax.

The Romanian authorities are mindful of the still fragile fiscal position. They agree with the staff that revenue collection (mostly VAT and excises), despite recent signs of improvement, is below potential, and that the current practice of special agencies having the right to approve tax holidays should be reconsidered. They also recognize that social security contributions are very high (60 percent since 1999) and need to be revisited in the context of a reconstruction of the entire system. On the expenditure side, the authorities have found it more and more difficult to keep personnel expenditure under control, and to manage the pension system. In general, they see a need for a structural review of expenditures. A technical mission from the World Bank is expected to undertake such a task early next year.

On monetary and exchange rate policies staff's assessment is mostly positive. The authorities agree that, during the two years under review, they have been confronted with tough challenges, but also lived in a more co-operative policy environment. Indeed, the former aspect was particularly critical in the first part of 1999, when the authorities had to deal with mounting pressures on the external sector. Tight liquidity conditions, associated with the government's decision to effect external payments in an exemplary manner, were reflected in an appropriate course of monetary and exchange rate policies, i.e., stricter monetary conditions and a flexible exchange rate policy consistent with market conditions. This stance of policies has been pursued in 2000 as well and has prevented a dramatic deterioration of the current account (in fact it has resulted in a massive improvement in the balance of payments), and in restoring confidence in the domestic currency.

The monetary authorities have reached a common language with the staff when discussing their intention to move, when conditions permit, toward a more transparent and effective framework for monetary and exchange rate policy. They share the staff's view that such a move should be initiated after Romania has brought wage growth under control and financial discipline has improved significantly.

Financial sector policies were high on the agenda of the consultation. The authorities have dealt with banking problems head on in recent years: unsound banks were removed from the system, while the regulatory and supervisory functions of the central bank have been reinforced. There are, however, two outstanding issues where progress has been less encouraging. First, the privatization of two banks and privatization/resolution of another bank have stalled partly due to a fading away of political support for such actions.

Second, the policy response to the collapse of the biggest mutual fund (FNI) last May has been partial. The authorities have been confronted with time-consuming legal procedures and interest groups that have delayed the clarification of the circumstances of that collapse.

Over the last three years more than 30 percent of the State Ownership Fund's (SOF) portfolio has been privatized, as against less than 12 percent during 1994-1997.This indicates that the efforts deployed during the last three years have been remarkable, but at the same time much remains to be done. The agenda for this year could not be fully achieved, while more transparent privatization procedures were expected to be implemented. This matter recently engendered a fierce political debate with some voices calling for a freezing of any privatization until after the election, with a view to adopt clearer procedures. The task of carrying on the privatization remains therefore with the new government.

Preliminary information (exit polls) suggests that the Party of Social Democracy in Romania (PDSR) has won the elections on November 26, closely followed by the Great Romania Party, a nationalist party, none of them holding a majority of votes cast. Most likely PDSR will be called to form a new coalition government. The candidates of the two parties mentioned above are also reportedly leading in the presidential race.

The Fund staff has worked over the last two years with the Romanian counterparts with dedication and professionalism. The authorities wish therefore to thank all of them for their efforts. The government and the central bank would also like to wish Mr. Zervoudakis, the mission chief, success in his new assignment.

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

Economic developments in Romania, since the Fund program was agreed to last year, are mixed. Inflation has declined significantly, the fiscal deficit, though wider than envisaged, remains at a substantially lower level, the current account has improved, and the exchange rate is relatively stable. The progress achieved in macroeconomic stabilization, however, falls short of what is needed to place the economy on a sustainable growth path. Specifically, macroeconomic stability remains fragile, while the overall stance of policies is unsustainable, owing to weaknesses in many policy areas. Recent developments, including the wage increases and shortcomings in expenditure control, point to risks in the fiscal area. The build-up of domestic arrears reduces confidence and reduces the monetary authorities' ability to effectively manage credit aggregates. Meanwhile, weaknesses in the financial system, and delays in the privatization of financial institutions, hampers intermediation and thereby keeps economic activity well below potential.

The difficulties facing Romania at this time are essentially homegrown, and the outlook is clouded by election-related uncertainties. Thus, minimizing the adverse implications of recent policy slippages necessitates the formulation of a broad-based policy package at an early date. Such a package should address both the near term as well as the medium-term challenges facing the economy. Romania's stop-go track record has taken a toll on policy credibility. Thus, a doable medium term-focus of reform measures is a necessary element in helping to signal a break from the past. Here, the importance attached to implementation should not be underestimated.

In the near term, the stabilization of the economy requires both fiscal as well as monetary measures. In the fiscal area, we share the assessment of staff that the fiscal deficit target should be treated as an upper limit, and that the 2001 budget should aim at a moderate tightening. Such a tightening would reduce stimulus to economic activity, but would avoid undue pressures at a time when inflation remains high. Success in this area hinges to an important degree on the authorities ability to control wage expenditures, as well as domestic arrears. Here, measurable progress is an important first step towards addressing the numerous medium-term fiscal challenges.

With the negotiations for EU accession underway, and the prospective fiscal costs of NATO membership, the authorities have little room for maneuver in fiscal policy in the medium term. To effectively meet the increased pressures on resources in the period ahead, fundamental reforms to the structure and administration of both revenues and expenditures are needed. With primary revenues at around 30 percent of GDP, and tax evasion very common, attempts to increase the tax burden may be counterproductive. The focus of revenue measures should therefore be on enhancing the efficiency of the tax system, updating standards with a view to meeting the EU norms, and improving tax administration.

The main risks to the fiscal outlook emanate from the expenditure side of the budget. In the recent past, considerable weaknesses in control became apparent, particularly at the local level. We therefore welcome the authorities intention to undertake a Public Expenditure Review with World Bank assistance early next year, and hope that the recommendation of the review will be implemented without delay. Looking ahead, pension reform remains key to ensuring long-term fiscal sustainability.

Once a coherent fiscal package is formulated, conditions should be in place for the introduction of a firm anchor to assist in the conduct of monetary policy. The authorities and staff present a useful analysis that would support the use of such an anchor in the form of either an inflation or an exchange rate target. There are clearly merits and shortcomings to both systems. In the case of Romania, we feel that the overall environment suggests that an exchange rate anchor would better serve the authorities for two reasons. First, the economy is expected to undergo significant further structural changes, which will undoubtedly affect prices and make reliance on a single, meaningful inflation figure difficult. Second, the weaknesses in the financial system, as well as the necessary reforms to the banking sector, will likely mean that monetary policy lags, as well as transmission mechanisms, are not easy to predict with adequate confidence. Under the circumstances, an exchange rate target will likely be easier to implement, and provide a sufficiently robust anchor for inflationary expectations.

Looking to the medium term, the authorities have set for themselves an ambitious goal by seeking to join the European Union. An equally ambitious structural reform agenda will be necessary to meet the expectations raised by this goal. Staff has pointed to a number of areas where considerable progress is needed for Romania to "catch up" with many other transition economies seeking EU membership. Foremost among these are enterprise privatization and banking sector restructuring. The private sector's share of GDP has been frozen at about 60 percent for the past three years, while the state ownership fund retains considerable control over enterprises. The expeditious implementation of the World Bank program in this area is a key measure that foreign investors, and others, will consider in assessing Romania's policy performance.

Romania has made significant progress since 1999. Although, policy slippages have occurred, the outlook is not bleak. Indeed, the fact that Romania has been recently upgraded by a rating agency underscores some of the positive developments that have taken place. We hope that the authorities will be in a position to formulate a reform program that can be supported by the Fund at an early date, and wish them every success in the period ahead.

Mr. Rustomjee made the following statement:

At the outset, I would like to thank the staff for the well-written set of papers as well as Mr. Wijnholds for his informative and helpful buff statement. The Romanian authorities deserve to be commended for the decisive policy measures taken in early 1999 to stabilize the economy and avert an imminent financial crisis, including a strong fiscal correction and tight monetary and incomes policies. As a result, the current account deficit narrowed to a more sustainable level, the external cost competitiveness improved and gross official foreign reserves replenished, reaching US$3.1 billion in July 2000, which represents 2.7 months of total imports. In addition, after having declined by about 14 percent during 1997-99, real GDP grew by 2.1 percent in the first half of 2000 thanks to buoyant exports, which rose by 25 ½ percent during the same period.

However, despite these encouraging results, the Romanian economy continues to lag in terms of both stabilization and reform levels and ranks lowest of the 12 European Union accession candidates. This is mainly the result of a "stop-and-go" approach to reform and stabilization that has been witnessed in Romania during the past 11 years. It is crucial that in the context of long-term stability and improvement of living standards such a pattern of economic policy-making be broken and that the authorities pursue vigorously their efforts to reform and stabilize the economy. As stressed by Staff as well as by Mr. Wijnholds the authorities need to focus their strategy on four prominent and urgent tasks: (i) disinflation; (ii) fiscal consolidation; (iii) financial restructuring; and (iv) enterprise privatization.

First, there is a need to disinflate the economy. Despite a decline in inflation from 55 percent at end-1999 to 45.5 percent in August 2000, CPI remains high and well above target levels. It is a fact that during the current year exogenous shocks, including drought and higher oil prices, impacted on consumer prices. However, as Staff note, a significant cause of inflation was increased domestic enterprise arrears as well as slippages in the state sector wage policy, including large increases in wages in state-owned enterprises and failure to implement employment cuts. Reducing inflation will require the authorities to decisively implement prudent financial policies including containing wage growth and improving financial discipline in the state sector.

Second, the authorities should continue their efforts toward fiscal consolidation which implies rationalization of expenditures and reform of the pension system. While important progress has been made with regard to the tax system, including a shift from direct to indirect taxes and unification of VAT rates, there is an urgent need for a structural review of expenditures. This includes prioritization of expenditures, improved targeting of social benefits and reduction of overstaffing. In this context, I welcome the assistance to be provided by the World Bank in conducting a Public Expenditure Review, early next year.

Third, it is critical to set up a healthy financial system by moving further with bank privatization and strengthening of bank regulation and supervision. Although state-owned banks accounted today for 45 percent of total liabilities of the banking system as compared to 71 percent at end 1998, the banking system, as stressed by Staff, is still unable to carry out its intermediation function effectively. Broad money to GDP ratios continue to be low and spreads between deposit and lending rates are unusually large. In addition, the collapse of a mutual fund earlier this year has highlighted serious weaknesses in the regulation and supervision of the nonbank financial sector. Confronted with cumbersome legal procedures and interest groups the authorities could not yet clarify the circumstances of that collapse. Against this financial sector background, it is recommended that the authorities expedite the privatization of the remaining state-owned banks, further enhance banking regulations and supervision as well as improve the regulation and supervision of the nonbank financial sector.

Fourth, it is crucial to accelerate the process of enterprise privatization and improve the business environment. Despite an important acceleration of privatization since late 1998, about 80 percent of all state-owned large companies still remain under state control. The task facing the authorities is challenging but the gains for the economy in terms of efficiency and financial discipline will be enormous. In this regard, it is important that the authorities proceed with the privatization of the 63 large commercial enterprises as well as of the “regies autonomes” on the basis of transparent procedures.

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

Mr. Jonas made the following statement:

When Indonesia's former energy minister Mohammad Sadli said, "Bad times make for good policies and vice versa," he could have been talking about Romania. In 1999, when Romania teetered on the brink of financial crisis, the government managed to make a strong response and avert the disaster. But once the immediate danger passed and elections approached, policy slippages reappeared. It is unfortunate to see Romania's traditional pattern of stop-and-go policies continuing to damage Romania's economic performance. The staff's comparison of Romania's economic and transition indicators with other countries shows just how far Romania lags behind the more advanced transition countries.

This does not mean that Romania has not made important progress in several areas, as shown by the reduction of the primary fiscal deficit and the improved current account balance. But this progress was insufficient and left the economy still vulnerable and macroeconomic policies still unsustainable. Piecemeal measures are not enough to stabilize the economy and restore growth. These goals require that stabilization policies and structural reforms be pursued simultaneously and with much greater vigor. Without support from structural policies, stabilization effort cannot possibly produce sustainable results. And what is even worse, attempting to do the job with fiscal restraint alone not only provides no tangible gains in stability or growth but wastes political capital.

I see the stagnation of privatization and the failure to improve corporate governance as the roots of Romania's problem. Excessive wage growth, and high and growing arrears, are the most obvious signs that structural reforms have not yet gone nearly far enough to alter the behavior of managers, especially in the state-owned enterprises. As long as companies operate under soft budget constraints, tight fiscal and monetary policies cannot bring inflation down.

The new government's most urgent structural measures include swift, transparent privatization or closure of the remaining state-owned companies: this would allow the World Bank to resume its support under the Private Sector Adjustment Loan. Progress with privatizing the 63 largest enterprises identified under the PSAL program has been very slow, and the authorities must do their best to get the privatization back on track and stick to their understanding with the World Bank concerning privatization strategies. There is also a need for a transparent privatization strategy that can ensure the legitimacy of the entire privatization process and improve the economic performance of the newly privatized companies. It is not only the quantity, but also the quality of privatization that matters.

The staff's comparison of Romania's privatization results with those of other transition economies shows that Romania's private sector produces 60 percent of GDP, a relatively large share not much different from other transition economies like Slovenia and Poland, which perform much better. I see several likely reasons why Romania's private sector does not perform as well as those in the more advanced transition economies. These include the nontransparent privatization sales, the weak financial discipline in state-owned enterprises (and its bad demonstration effect on the private sector), and low level of financial intermediation that does not produce sufficient financing for new investment.

This low level of financial intermediation reveals that much more work is needed in the financial system as well. Recently there has been some progress, and I welcome the privatization of two banks, and the closing of four problem banks, one state-owned and three private. But in fact Romania's banking sector remains weak and cannot perform intermediation effectively, while the reluctance to privatize or otherwise resolving the remaining state-owned banks is no help. I hope that one of the new government's first priorities will be to set a firm schedule for privatizing the BA, BCR, and Savings Bank, and that this privatization will follow IMF/World Bank recommendations. The authorities' unwillingness to discuss a privatization strategy for BCR with the staff is somewhat surprising. I can see no strong reason for confidentiality to be an issue here.

I was also concerned by the collapse of the major mutual fund, which calls for rapid action to improve regulation and supervision in the nonbank financial sector. Allowing a segment of the financial sector to operate without sufficient regulation and supervision will continue to block the development of effective financial intermediation. The manner of resolving the FNI incident also leaves much to be desired. I urge the authorities to prosecute the scheme's main beneficiaries. I also regret that the authorities have reversed an earlier decision and now intend to provide compensation to all FNI investors. While politically popular, such a move would create the wrong incentives for future investors.

About macroeconomic policies I am less concerned than I am about structural reforms. I agree with the staff that the fiscal situation remains fragile, and that the medium-term fiscal deficit target of 3 percent of GDP should be regarded as an upper limit. The possible availability of relatively cheap financing in the form of official assistance should not be the only consideration in deciding what represents the best trajectory for the fiscal balance. The staff rightly insists that there must be future room for using fiscal policy as a stabilization tool. This will require undertaking several major reforms of the public finances, including prioritizing expenditures, better expenditure control in local budgets, less earmarking of public revenues for specific spending purposes, and launching the pension system reform.

I have no major problems with the conduct of monetary policy. I do note that the NBR faces a difficult situation in which monetary policy's effectiveness against inflation is eroded by the corporate sector's lack of financial discipline. In addition it seems that monetary policy is not entirely proof against fiscal dominance, as shown by the pressure on NBR to lower the interest costs of budgetary financing. In light of these constraints, and the higher than expected inflation in 2000, it could be extremely difficult to achieve the goal of reaching single-digit inflation in 2004.

It would be particularly unrealistic if the present monetary policy framework is left in place until 2003, as it could be under the action plan submitted to the European Union. I agree with the authorities that it would be quite risky to introduce more explicit inflation or exchange rate targets without bringing the non-monetary sources of inflation under control. I can only hope the authorities will succeed in doing so that they can introduce an explicit monetary policy framework before 2003. In view of the relatively high inflation, and the undeveloped state of Romania's financial sector, targeting inflation or monetary aggregates could be particularly difficult. For this reason exchange rate-based stabilization seems preferable, accompanied of course by a clearly defined exit strategy.

Looking into the future, I see that the present stand-by arrangement expires next February. I do not think it will be possible to renew disbursements under this arrangement. But the Fund should not abandon Romania at this difficult juncture. If the new authorities cooperate closely with Fund and World Bank, and pursue policies that are consistent with EU accession, it should be possible to negotiate a new stabilization and economic reform program soon, and to support it with renewed assistance. Perhaps the introduction of a more explicit monetary framework could be part of this program. Romania's external situation remains fragile, and despite its recent success in issuing eurobonds, at this stage it cannot count on sustained private external financing. On the other hand, a new arrangement with the Fund would unlock relatively large flows of official assistance, which should help sustain the nascent recovery. And as growth strengthens, it should become politically possible to pursue difficult structural reforms, including the closing of loss-making enterprises. This, in turn, should make room for a gradual increase in private external financing.

I hope that the new Romanian authorities will soon be able to devise a sufficiently ambitious and comprehensive policy package that can gain the support of the official international community.

Mrs. Steinbuka made the following statement:

I am in broad agreement with the staff appraisal, and would like to make some comments for emphasis.

First, the process of transition has been much less favorable for Romania than for most of the transition front-runners. Nevertheless, in the past two years Romania has made progress on macroeconomic stabilization and structural reforms, growth has resumed and exports have increased. Large corrections in the fiscal accounts and in the exchange rate improved the country's external position. The large reduction in the current account deficit, the full and timely payment of all external obligations, and the rebuilding of official reserves were also important achievements.

The government's determination regarding reform opened the way for EU accession negotiations. However, the European Commission made it clear in its recent progress report that Romania cannot be regarded as a functioning market economy, and the next government has to accelerate reforms in order to avoid falling even further behind the other applicant countries. It was stressed in the progress report that there is an urgent need to continue with full implementation of the programs agreed to with the international financial institutions. However, progress in implementing the program supported by the Fund's Stand-By Arrangement and the World Bank has been jeopardized by recent and respective policy slippages.

During the discussion in June on the first review under the Stand-By Arrangement, we emphasized the serious risks to the program's implementation. Those major risks were associated with maintaining political stability in the run-up to the elections and promoting noninflationary growth. These risks seem even more serious today. The latest indications suggest that the stabilization gains in Romania remain fragile. Indeed, inflation is high and the sustainability of the situation is doubtful. Rising oil prices, the falling rate of the euro, and the severe drought have contributed to a rising fiscal deficit, and, in particular, higher than targeted inflation. These exogenous factors are beyond the government's control. I am nevertheless convinced that the main reasons for the higher than targeted inflation and budgetary shortfalls are the lack of financial discipline and policy slippage in the areas of state sector wages and domestic arrears, which continue to grow. The authorities also failed to withstand pressures from managers and trade unions to prevent increases. This is regrettable, not only because strict control over wages and arrears is an instrument to accelerate the restructuring of loss-making monopolies, but also because wage growth in excess of productivity growth adversely affects external competitiveness and poses risks to external stability. Putting public finances on a sustainable path remains one of the government's imminent challenges. Urgent measures are needed to improve financial discipline among public sector companies, and to carry out important reforms in the social security and health care areas.

Insufficient structural reforms, corruption, and massive tax evasion have undermined the progress made on macroeconomic stabilization. The uncertainty surrounding the legal and institutional framework and the uneven commitment to sustained reforms have hindered economic development. A very large part of the enterprise sector has yet to start restructuring or it is still in the process of doing so. There is a strong need for bank privatization and strengthened bank regulation and supervision.

Mr. Wijnholds correctly noted that the decline in economic activity has been arrested and reversed. However, growth arises primarily from the export of unprocessed food and low quality textile and leather goods produced at low cost and by a largely unskilled labor force. Expansion in these areas cannot be a basis for the long-term development of the economy. Moreover, investment has continued to fall delaying the required [monetization of the supply side of the economy??] and putting prospects of future growth in doubt.

I hope the new government will continue the consistent implementation of market reforms recommended by the staff. I also hope that the goal of EU accession will continue to provide a strong impetus to the reforms. The wide political consensus on the medium-term economic strategy, which is broadly consistent with the Fund's program, shows that there is a clear agreement in Romania of the need for economic reforms. It is important for the authorities to adhere to macroeconomic and structural policies, which remain one of the most pressing challenges.

Ms. Lundsager made the following statement:

Let me begin by noting that, while this chair generally does not praise the quality of staff reports, we found this set of papers to be very well presented and comprehensive.

Turning to the report, the profound lack of progress in Romania over the past 11 years, especially when compared to other countries in the region, is, indeed, sobering. This outcome is evidenced not only by the failure of several IMF programs, but also by the fact that every area of economic policy faces significant risks and requires further—and in many cases fundamental—reform. Perhaps most disappointing is the apparent failure of the authorities to learn from the lessons of other countries in transition, as outlined in the most recent WEO. Based on the comments of the European Commission as quoted in the staff representative's statement, Romania must dramatically turn things around before it has any chance to join the European Union.

Fiscal policy has been at the root of many of the policy setbacks during the transition. In the first 6 to 7 years of the 1990s, extensive quasi-fiscal deficits had the effect of undermining the enterprise sector, the nascent banking system, as well as external and monetary policy. Even after the more recent attempts to bring these quasi-fiscal deficits onto the state budget, and notwithstanding improvements in the primary balance, the government has never been able to gain control over expenditures. This is highlighted by the fact that the authorities, once again, are unlikely to be able to achieve the deficit target of 3.5 percent of GDP, which was itself a loosening of the initial target. While some of this slippage is no doubt due to the impact of the drought and high oil prices, the primary factor is weak policy implementation, particularly on the expenditure side.

While we could enumerate a lengthy list of specific weaknesses in the fiscal situation, the most important point made by staff is that Romania's expectations are out of line with its revenues. We agree that Romania must address the fundamental question of whether it wants to be a low-tax, low-service country, or a high-tax, high-service country. The economy cannot continue to collect modest revenues, while attempting to offer the full benefits of a welfare state. This situation will only worsen as Romania reforms its social welfare system and aims to take on the additional fiscal burdens of EU and NATO accession.

Inflation has been a persistent problem in Romania. Unlike last year, when high inflation was primarily due to the rapid pass-through of a steep depreciation of the leu, this year inflationary pressures can be attributed to the authorities' inability to maintain wage restraint and to curb an environment fertile for domestic arrears. In this vein, we agree with Mr. Wijnholds that disinflation necessitates significantly heightened fiscal discipline. In addition, as Ms. Lissakers and Mr. Bernes noted at the first review of the Stand-By Arrangement, and as staff states in the report, a more transparent monetary and exchange rate framework that focuses on a limited set of explicit goals will also be needed to successfully bring inflation under control.

Romania has made very limited progress in privatizing or restructuring its large state-owned enterprises, where this scenario is inextricably linked to the continuing problems of excessive wage growth and domestic arrears accumulations. As the recent WEO notes with regard to counties in transition, "the most effective way to promote enterprise restructuring now appears to be to foster competition and impose hard budget constraints." We urge the authorities to take heed of this lesson.

The lack of progress in privatization and restructuring in the banking sector is also disturbing, particularly in the cases of Banca Agricola and the Romanian Commercial Bank. And the latest information as provided in the staff representative's statement concerning the decision to recapitalize Banca Agricola is clearly a return to the proven ineffectual policies of the past. We agree with staff recommendations regarding these banks and would ask staff to comment on the authorities' decision to recapitalize Banca Agricola.

While the growth of privately owned banks is encouraging, we note that reform is still needed to ensure that Romania is not replacing money-losing state-owned banks with private banks susceptible to collapse. Notably, there is room for substantial improvement in the implementation of prudential regulation, and in cases where banks are found to be insolvent, they should be liquidated expeditiously.

The collapse of the National Investment Fund was a considerable setback for non-bank financial markets in Romania. It is unfortunate that it took the collapse of a major mutual fund to highlight the cost of poor financial-market supervision, and we look forward to the implementation of appropriate reforms, as pledged by the government during its first program review.

We encourage the authorities to foster growth in the private sector, highlighting the importance of improving governance and implementing anti-corruption measures. A new U.S. Agency for International Development report asserts that Romania's burdensome bureaucratic and regulatory process is a key obstacle to private sector growth, while corruption has also been identified as a major impediment to the Romanian economy. We urge the government to fully implement the recently-enacted anti-corruption law and to follow up by providing additional enforcement authority. Improving the business environment will be crucial to attracting both domestic and foreign investment.

We are disappointed that Romania was unable to complete the second review of its Stand-By Arrangement due to the slippages in wage policy and privatization. We encourage the new government to address the structural reforms necessary to build upon recent improvements in economic growth and the external situation. Delaying or reversing reform will simply lead to a repeat of the poor results of the 1990s. Now is the time to restore policy credibility, as noted in Mr. Himani's statement.

Finally, as Mr. Zervoudakis leaves this account, we would like to thank him for his tireless efforts in trying to help Romania through its economic difficulties.

Mr. Vittas made the following statement:

Since the previous consultation two years ago, Romania's economic performance has shown some modest, but nonetheless welcome signs of improvement. The external current account position has strengthened noticeably, foreign reserves have been rebuilt, inflation has been reduced somewhat, although it remains very high and, after a long period of decline, economic activity has begun to recover boosted mainly by a good export performance. Perhaps most importantly, despite significant shortfalls in external financing, the financial crisis that appeared imminent only a short while ago has been averted. Moreover, some difficult steps have been implemented to reduce weaknesses in the banking system and the state enterprise sector and promote other structural reforms.

Regrettably, however, the strong stabilization and reform policies that had contributed to the improved economic performance have not been sustained in the recent past. On the contrary, in the run up to the recent elections, some backtracking has occurred in pursuing the structural reform agenda, and significant slippages have once again been allowed to occur with regard to meeting objectives for wage discipline and for addressing the perennial problem of domestic enterprise arrears. In addition, decisions have been taken that threaten to partially reverse earlier progress toward a sustainable fiscal position These developments have not only made it impossible to conclude the second review under the Stand-By Arrangement; as staff correctly points out, they have also put at risk the sustainability of the modest macroeconomic gains so far achieved.

Against this background, it is clear that the new Government will be faced with the major challenge of restarting and invigorating the stabilization and reform effort. In this regard, the Government will have the not insignificant advantage of being able to draw on the MTES already prepared in the context of Romania's discussions on accession to the EU. Nevertheless, it will be important to elaborate at an early stage the specific policies that will be pursued over the next several years to achieve the ambitious objectives set out in the MTES. Moreover, as pointed out by Messrs. Shaalan and Himani, firm implementation of these policies will be crucial inter alia in order to demonstrate that the stop-and-go approach of the past is definitely being abandoned, to establish gradually some policy credibility and, more generally, to improve Romania's medium term economic prospects.

Regarding the contents of such policies, it is evident from the staff report and Mr. Winjholds's statement that there is a substantial degree of consensus between the authorities and the staff on what needs to be done. I will therefore limit myself to a few brief observations.

First, I believe it is worth emphasizing that in the near term a key priority should be to ensure adequate wage restraint in the government sector and the public enterprises. Such restraint is needed to facilitate progress toward strengthening the fiscal accounts and to help resolve the problem of enterprise arrears. But it is even more crucial as a means of safeguarding external competitiveness without resort to substantial currency depreciation, which in the final analysis undermines the attainment of disinflation objectives and makes it difficult to adopt a transparent monetary policy framework.

Second, concerning fiscal policy, it seems to me that the main task facing the authorities is not so much that of reducing further the deficit but rather that of improving the administration of the tax system, rationalizing public expenditure, including social spending, and reforming the pension system. In each of these areas the reform agenda is daunting. Having said this, however, let me add that I fully agree with staff that the MTES target for the deficit should be viewed as an upper limit. I also share staff's view that the authorities should stand ready to tighten the fiscal stance if a recovery in confidence were to lead to substantial capital inflows and an unwarranted upward pressure on the real exchange rate (either though a relaxation of domestic liquidity and a pickup in inflation or through a nominal appreciation of the lei in the forex markets).

Third, I welcome the progress that has been made in bank reform and in strengthening the supervisory and regulatory framework as well as the increased reliance by the NBR on market friendly instruments of liquidity management and. However, I strongly agree with the staff and previous speakers that much more remains to be done to put the banking system on a sound basis and to eventually allow monetary policy to focus on its primary task of reducing disinflation. In view of this, the recent decision of the authorities to backtrack on their commitment to liquidate Banca Agricola, following the failure of privatization efforts, is regrettable and I wonder whether there is scope to reconsider it.

Fourth, I would stress the importance of speeding up the process of reforming state-owned enterprises and moving ahead with their privatization on the basis of the improved and transparent procedures sponsored by the World Bank in the framework of its PSAL loan to Romania.

Finally, I wish to underscore the need to address in a decisive manner the still pervasive governance issues.

In concluding, let me wish the authorities success in meeting the difficult challenges that lie ahead.

Mr. Cho made the following statement:

The Romanian economy now stands at an important juncture both economically and politically. The economy showed modest signs of growth after three years of recession. Unfortunately, the program review was not concluded. The necessary deep and broad reforms have been delayed, and slippages in the areas of domestic arrears coupled with excessive real wage increases remain a stumbling block for economic stabilization. Moreover, the recent election led to delays in the implementation of recent reform measures owing to the authorities' indecisiveness and political pressure. The political implications of the recent election are still uncertain. However, the new administration's major task will be to accelerate the broad reform initiatives in order to keep up with other accession economies.

I would like to join other speakers in commending the staff's analytic papers in comparing Romania's problems and issues. While agreeing with the staff's major assessment, there are a few observations I would like to make.

I concur with other speakers that reducing inflation and wage increases are the key to economic stabilization. We all know that there is no easy way to reduce inflation but through a strengthened macroeconomic framework. However, there is also a need for ensuring the participation of representatives from government, employers, and employees to find a way to lower wage pressure as well as inflation expectation.

On the fiscal front, the authorities face two challenges in the short run, the fiscal deficit, which is mainly caused by high wage increases and should be curbed by streamlining expenditure and by strengthening [pension??] administration. In the medium term, as pointed out in the background paper by the staff as well as by Ms. Lundsager, the authorities should establish whether they are heading toward a system such as a European welfare state or one that is market oriented; I hope it is the latter. Considering their current stage of economic development and the need to invigorate the private sector for growth, the authorities should consolidate expenditure and improve tax administration.

On the financial sector, some improvements have been made. The staff points out that the resolution of deficit ridden Banca Agricola and privatization of the Romanian Commercial Bank should be done without delay. Postponing the reform of the financial sector not only increases the cost of [reforming??] the financial structure, but also complicates the reform process by aggravating the already serious problems of shedding employees as well as resolution of nonperforming loans and loss provisioning. I hope the authorities give high priority to tackling these issues.

Lastly, I hope the authorities redouble their efforts to observe international standards. On this note, I wish the authorities further success in their endeavors.

Mr. Hendrick made the following statement:

I would like to thank staff for the useful set of papers for today's Board discussion, which provide a clear picture about the economic and social challenges faced by the Romanian authorities. Despite the external shocks and domestic problems, the authorities have managed to improve the fiscal and external accounts, while reducing inflation and attaining economic growth in 2000 after three consecutive years of recession. However, as Mr. Wijnholds clearly indicates in his useful, candid, and comprehensive buff statement, there are very important issues still to be addressed to place the Romanian economy in a sustainable, non-inflationary growth path.

The recent assessment of Romania's progress toward meeting the Copenhagen accession criteria by the European Commission is not encouraging. It is a little disappointing that after 11-year of a transition process, and three Stand-By programs with the Fund, the European Union considers that Romania "has not substantially improved its future economic prospects." The widespread poverty and high unemployment call for decisive actions from the authorities. Investors and the international community are in a wait-and-see attitude until it becomes clear what will be the policy orientation of the new government after the presidential runoff election this December 10. To boost investors' confidence, I strongly encourage the authorities to take this opportunity to provide a good signaling to the markets about their willingness and commitment to press forward with the structural reform process and maintain sound macroeconomic policies.

I share the conclusions and main policy recommendations provided by staff, and welcome the fact the authorities are equally agreeable. Nevertheless I would like to ask a few questions for clarification.

Box 1 of the staff report envisaged for 2000 a fiscal deficit higher than the authorities estimated of 3.5 percent of GDP. The staff report indicates that recent developments seem to confirm the underlying risks to fiscal policy. Considering the slippage in domestic arrears and wage policy on the end-September performance criteria, I wonder whether there is any chance for the current Fund-supported program, which ends in three months, to be on track before expiration, and whether the authorities has shown some interest for a new Fund-supported program in the near future. Staff comments would be appreciated.

Table 2 of the staff report shows that the financing gap for the balance of payments in 2000, originally estimated in US$ 747 million is zero in the revised projection. At the same time, the item net errors and omissions is now estimated in a positive flow of US$ 874 million vs. a negative flow of US$ 75 million in the previous staff report. I wonder if the surveillance exercise for the external accounts has any meaning with the size and dramatic changes in the direction and absolute value of the errors and omissions in the balance of payments. The review of Fund-provided technical assistance in Appendix 1 provides some hints on these problems. However, it is not clear to me if Mr. Hofman and the PHARE project by the European Union will be able to fix these deficiencies during the five years period. I would appreciate some additional information by the staff.

The recent Euro 150 million bond issue with a 5-year maturity at 11.6 percent seems a good deal for Romania. However, it is not clear that this bond issue fully reflects the degree of access to the voluntary international capital markets in a sustainable basis or is an isolated case that cannot be generalized as the ability of the country to obtain external financing. Staff comments would be appreciated.

Regarding the authorities' decision to recapitalize the Banca Agricola, with a view to keep it in operation indefinitely, according to the staff update, I would appreciate some additional information from the staff or the authorities about the reasoning behind this decision. For instance, there is a systemic risk in the financial system which would advice to take this course of action? It is merely a result of political considerations?

Finally Mr. Chairman, like other speakers I found interesting the question of philosophy posed by the staff in the chapter of Public Finances in the Selected issues paper. Indeed, the authorities will have to decide between a full-fledged welfare state or a smaller government more attuned to recently observed revenue performance. I believe that transition countries like emerging economies cannot afford to run a full-fledged welfare state.

With these remarks, I wish the Romanian authorities the best in their period ahead.

Mr. Sugeng made the following statement:

First of all, we would like to thank the staff for a well-written paper. Since embarking on transition to a market economy, progress in adopting structural reforms has been made, improving market confidence. After three years of economic contraction, sustained growth is nowhere in sight in the year 2000 as indicated by high growth of both exports and imports. However, high inflation remains a major concern, while other CEE countries have begun to handle this problem. We welcome the authorities' intention to reduce inflation to reach a single digit in the near term. It will be an essential element for establishing sustained economic growth.

There are, however, difficult challenges and weaknesses that the authorities need to address in the years to come. While we concur with the objective of the reduction of inflation, further work needs to be done to elaborate a sound framework in the macro side. In the fiscal front, the authorities should emphasize the need for a more disciplined fiscal policy (including a prudent wage policy), avoiding the recurrently larger fiscal deficit stemming mainly from the wage increase. Concern in this matter should be addressed as Romania is still in the preparation of EU accession and NATO membership that could bring an expansive impact on expenditures. Efforts to address weaknesses on the revenue side should also follow suit. Current practices that allow enterprises and corporations to have significant amounts of tax arrears need to be halted. It is clearly an area where more efforts are warranted. In addition, as tax evasion persists, we would encourage the authorities to strengthen tax administration.

On the monetary side, meeting the inflation target as set out in the Medium-Term Economic Strategy (MTES) will likely pose a serious challenge. In our mind, the current monetary framework has not yet provided adequate assurance for achieving the targeted inflation. Since the monetary policy has more than two goals under the current framework i.e., reducing inflation and strengthening external position; it will be difficult to get optimal results, as these two objectives are contradictory. In this context, as the authorities' main objectives in the medium-term is to reduce inflation, the center of monetary policy should be directed to achieve this goal. Low inflation is a prerequisite for laying a firm foundation of growth in the long run. Based on the transition experiences in neighboring Central European countries, it could clearly be seen that economic recovery was achieved only after the economy has been stabilized and inflation has been considerably brought down. Therefore, under this setting, a flexible exchange rate movement should be permitted, thus allowing a buffer for external shocks.

Along with the move toward the EU accession, addressing structural problems that Romania faces is of utmost importance, especially in enhancing Romania's international competitiveness through enhanced efficiency of the economy. With this basis, relying too much on the depreciation of the leu in ways to increase the competitiveness could be lessened. In this regard, we encourage the authorities to move forward with their privatization agenda as the bulk of large companies remains under state control. This program is indeed important to help enhance the fiscal position. In addition, learning from the collapse of a mutual fund, we see the urgent need of having an improved regulation and supervision of non-bank financial sectors.

Finally, we wish the Romanian authorities every success in facing their challenges.

Mr. Le Gal made the following statement:

Since the beginning of Romania's program our chair has always emphasized the need for reform in Romania to make progress both on the transition and the EU accession, and we always supported the options that favored reforms. It is therefore a disappointment to see that reforms have stalled to the point that we can only discuss an Article IV consultation and not a program review.

From reading the report and Mr. Wijnholds's statement, as well as from listening to the discussion, it seems that there is a certain degree of consensus on the analysis. There is a need to increase financial discipline at all levels and to reinforce monetary policy by adopting a clear framework. Such a policy will be made possible and sustainable only through consistent and continuous structural reforms.

As we already stated in June, the lack of financial discipline and the pervasiveness of a soft budget constraint points to an insufficiently advanced transition, as is confirmed by the EU progress report. Without a strong resolve from the authorities, there will only be limited – if any – progress in this area. The first steps under the program until the last review were encouraging. Indeed, more has been done in this short period than before and improvement in the external environment could have provided a good opportunity to pursue and to complement initial achievements. However, the report rightly regrets the "missed opportunities" and one could add that there was even some backsliding, in terms of wage increases for instance, during the run-up to the elections.

The accumulation of domestic arrears and the lack of financial discipline are the key questions and should be addressed by the next government as soon as possible. A broad support must be achieved on this issue since all levels of government as well as all public and private companies must abide by financial discipline. Moreover, any progress in this area will be durable only if structural reforms, including restructuring and privatization of the enterprise and banking sector, are actually implemented.

In spite of the monetary policy tightening initiated in 1999, inflation has overshot the program's target. This is hardly a surprise, given the structural weaknesses and lack of discipline on the fiscal and financial sides. Indeed, monetary policy had to accommodate high inflation at a time when wage growth and an excessive fiscal deficit endangered the external position. Therefore, we agree with the staff that a more transparent monetary framework should be adopted, although we think the recommendation could be more straightforward. It is interesting to note that most of the other accession countries have or—have had at least in a first phase—an exchange rate anchor. On the other hand, Mr. Himani gave two reasons why inflation targeting would be difficult to implement in Romania, first, because structural changes are likely to affect prices and, second, because monetary policy transmission mechanisms are uneasy to predict. Could Staff elaborate on the necessary prerequisite for a successful introduction of a clear monetary framework? Needless to say, the success of whatever monetary framework may be chosen will depend on the implementation of the adequate policy mix and the continuation of structural reforms. In this regard, could Staff or Mr. Wijnholds tell us what the prospects are for further policy dialogue with the Romanian authorities in the coming months?

The staff representative from the European I Department noted that Banca Agricola (BA) was to have been liquidated by end-June under the Fund-supported program, had it not been privatized by that time. The liquidation was postponed because of investor interest that did not translate into a firm offer. It was also disappointing that the authorities had decided to recapitalize BA before it was privatized. The program had required that BA be privatized before any recapitalization took place. The authorities would most likely be of the view that BA was recapitalized to help its privatization prospects.

Prospects for the completion of the next review were not favorable, the staff representative explained. There had been considerable slippages under the present program, and it would take time for the new government to formulate its policies. It was difficult to predict when the new government would want to start a policy dialogue with the Fund, as there were no pressures on Romania's balance of payments position and the new government also might not want to appear too eager to deal with the Fund. Nevertheless, discussions could be expected to start in early 2001 as markets and the European Union viewed them as essential, particularly for Romania's EU accession prospects.

The tables in the staff report indicated that Romania would not have a financing gap because it was assumed that the Fund, the World Bank, and the EU would provide financing, the staff representative said in response to a question from Mr. Hendrick.

Large errors and omissions items had complicated surveillance and program design, the staff representative remarked in response to another question from Mr. Hendrick. The errors and omissions projection in the staff report was based on data from the early part of 2000. The staff had tried to ascertain what constituted the errors and omissions, and believed that they likely included remittances from workers, which for some reason might not have gone through official channels and missed recording of foreign direct investment.

It was difficult to judge Romania's access to the Eurobond market over the recent months, the staff representative noted. Nevertheless, it could be expected that access would continue if the new government pursued prudent polices that resulted in strong economic performance.

Mr. Hendrick asked what the reasons were behind the authorities' decision to recapitalize Banca Agricola.

The staff representative from the European I Department replied that the staff had reached an understanding with the authorities that Banca Agricola would not be recapitalized, except in the context of firm privatization. The staff had stressed that it should not be recapitalized simply for the purpose of keeping it in operation; it should have been either privatized or liquidated. The authorities had not offered any official explanation to their decision to recapitalize Banca Agricola.

Mr. Wijnholds added that the authorities had tried to privatize Banca Agricola (BA). Those attempts had failed because the offers made were below expectations. Consequently, the authorities decided to recapitalize BA while continuing to try and sell it. It was also politically difficulty to liquidate BA shortly before an election.

Mr. Hagan made the following statement:

> I agree with the analysis in the staff paper. There is certainly little to add to the conclusion that while there have been some achievements in the past year, much was not done. As we said in the discussion in June 2000, a piecemeal package of implementation where some of the right things are done

would likely bring the desired results. The election obviously did not make program implementation any easier, but it is disappointing that after the significant achievements of 1999, the Romanian authorities could not build on this and press ahead with much needed fiscal and structural reform.

The statement issued by the staff yesterday on the latest developments simply emphasizes areas of structural reform and fiscal policy where policy has been inefficient. As the staff representative from the European I Department has just told us, the Stand-By Arrangement appears to be dead. It would seem desirable that Romania should have a program with the Fund to assist its economic recovery. However, we now have added yet another program to the list of those that did not progress very far and went irretrievably off track after being agreed to. This history, and in particular the lack of a clear political consensus which could command broad-based support in the economy, particularly on the structural side, should make us cautious about agreeing to another program with the authorities in 2001. I would suspect that we need to see very strong and demonstrable commitment and substantial prior actions from the new government before we contemplate further use of Fund resources. As the staff representative said, some of the statements from the new authorities in the run-up to the election may make this quite difficult.

As others have noted, there is probably little disagreement around the Board as to what the correct policy prescriptions are. Mr. Wijnholds's statement on behalf of his authorities also suggests a great deal of consensus on the appropriate policies. It now seems essentially a question of whether the political will can develop to make a serious and sustained effort at implementing the possible.

Mr. Szczuka made the following statement:

The return of growth to Romania after three consecutive years with declining GDP is certainly good news. I also welcome the progress achieved in some other areas like tax reform or banking sector restructuring. However, the 1.5 percent growth expected for this year is still a modest one, and is mainly supported by strong results in exports. This recent improvement in export performance reflects, to a large extent, the economic upswing in the EU area. To make it more sustainable the authorities should aim at both preserving the competitiveness, which has been somewhat eroded by the real appreciation of the lei against the euro, and at improving the structure of exports, now dominated by low value-added goods. Against the background of the strong external demand, the relatively weak retail sales indicate that domestic demand has remained sluggish. Meanwhile, inflation continued to be much higher than programmed, with consumer prices increasing by more than 42 percent during the year up until October. Even after taking into account the impact of such unfavorable factors as the high oil prices and severe drought, there are good reasons to believe that the program assumptions with respect to inflation were not realistic, as this Chair pointed out in our July statement. I wonder whether staff could present their assessments of the relative contribution of such factors as oil and food prices, VAT unification and pay increases to the overshooting of this year's inflation target. Could the staff also explain why in their view slippages in wage policy played such a crucial role even though the wage performance criterion for the first half of 2000 was not breached.

I tend to agree with the staff that the "stop-and-go" approach to stabilization and structural reform can be seen as the main reason for the less than satisfactory results of the transition process in Romania. This country provides a good example of how political constraints can systematically obstruct the choice and/or implementation of good economic policies, and how powerful interest groups can block socially beneficial reforms. Last year's threat of a balance of payments crisis and the ensuing period of political consensus allowed making decisive policy corrections and undertaking some positive structural changes. However, with the improvement in the external position and with elections approaching, the reform effort has slowed down once again and the financial discipline has been relaxed. This resulted in serious policy slippages in such crucial areas as state sector wages, employment in the public sector and domestic payment arrears as well as in renewed delays in the restructuring and privatization of banks and enterprises. These unfavorable developments can jeopardize the appreciable progress in stabilization and reform that has been achieved over the past two years.

Lack of financial discipline and weak corporate governance occupy a very prominent part on the list of problems besetting the Romanian economy. They result in constant pressure for monetary accommodation of fiscal and quasi-fiscal deficits. Although the monetary policy has gained some strength with the reforms that have been introduced after 1996 it seems rather unlikely that this recurrent problem can be successfully tackled within the existing institutional framework. A move to a new monetary policy framework with enhanced central bank independence seems to be indispensable to overcome the political influence on monetary policy. While we see some merit in the position that has been advanced by the authorities, and accepted by the staff, that it would be premature to move to an explicit inflation or exchange rate targeting framework we find it a little disappointing that this central issue has not been given much attention in the otherwise very well prepared and comprehensive staff report and the background paper. Staff has neither indicated its position on the ultimate choice between direct inflation targeting and exchange rate based regime in Romania (on this issue I tend to agree with Messrs. Shaalan, Himani, and Jonas that at this stage of Romania's transition an exchange rate based regime might be preferable) nor discussed the potential disciplining effects of introducing a strict monetary regime.

Watever the decision on the selection of the ultimate regime may be, and pending its implementation, it is clear that the overburdened monetary policy alone can not be effective in bringing down inflation and needs to be supported by improvements in fiscal and income policies, by the acceleration of structural reforms and by other measures to improve financial discipline. I can be very brief on what needs to be done in these areas, as I broadly agree with the previous speakers and with the staff appraisal. Introduction of wide-ranging expenditure and pension reforms is of crucial importance for the achievement of fiscal sustainability. There is also a need to strengthen control over spending at the local level and to address the issue of widespread tax (and in particular excise tax) evasion. Privatization or liquidation of state-owned firms has to be accelerated, firstly, to avert further losses through subsidization and, secondly, to overcome political constraints with regard to wage discipline. The government recently announced that, starting December 1, it intends to reduce the social security contribution level in order to cut labor costs. While providing a necessary stimulus for employment, this measure is clearly adding to pressures on the budget. The same can be said of the recent decision to raise the minimum wage from 700,000 to one million lei.

Regarding financial sector policy, we support the staff's call for further privatization of state-owned banks and a further improvement of banking regulation and supervision, aimed at increasing the health and efficiency of the banking system. An efficient banking system is vital for sustaining the economic recovery.

Before concluding, I would like to ask the staff to provide their assessment of the recent trends and developments in the black (or gray) part of the Romanian economy, which according to some estimates comprises about 30 to 40 percent of Romania's GDP, but has not been mentioned in the staff report. I would also welcome staff's response to the very important statement attributed to the Romanian authorities, in which they claim that the Fund's PSI policy adversely and unfairly impacted the Romanian economy.

With these comments I wish the Romanian authorities further success in advancing the transition process.

Mr. Lushin made the following statement:

Let me start with commending the staff for comprehensive papers that present a candid analysis of the situation and economic developments in Romania.

Over the recent years, the Romanian authorities have made considerable efforts in stabilizing the economy and implementing the reform agenda. Especially notable is the progress achieved over the past two years, when the threat of the financial crisis required the authorities to take forceful policy measures to address the existing imbalances. As a result, the external position of the country has improved substantially and market confidence was largely restored, as evidenced by recent successful debt placements in the international markets. However, due to a “stop-and-go” approach to reforms and policy implementation, the Romanian economy is still well behind other transition countries in Central and Eastern Europe, and its EU accession is heavily complicated by persisting macroeconomic imbalances and insufficient structural reforms. Notwithstanding recent good record, Romania urgently needs to push forward reforms to address structural deficiencies and to build-up a solid basis for a well functioning market economy.

In the run-up to the recent elections noticeable slippages occurred in such areas as domestic arrears and wage policy in the public sector. This has further fueled inflation that went out of control and amounted to more than 40 percent, far above the expected outcome. The progress achieved so far happened to be insufficiently strong to withstand political uncertainties and unfavorable external conditions. We regret that the program supported by the Stand-By Arrangement went off track in the second half of 2000 owing to policy slippages. We sincerely hope that a new government to be formed in the near future will remain adhered to close cooperation with the Fund and that it will continue implementing a vigorous reform agenda aimed at bringing the economy to sustainable growth.

We broadly agree with the thrust of the staff appraisal. Also, Mr. Wijnholds’ statement provides a sharp and very well focused description of the challenges facing the Romanian economy at this point. Below we suggest a few remarks on specific policy issues.

Considerable efforts to strengthen the fiscal position have been done in 1999 and in the first half of 2000. However, these fiscal improvements were weakened in the second half of the year by a high wage spending and a shortfall in the tax collection. Because of the election pressures, the authorities were unable to restrain the wage bill in the public sector as well as to implement cuts in the public sector employment originally envisaged by the program. Such developments are a cause of concern, since the scope for increasing tax burden to accommodate any additional expenditures is limited by its already high level, which causes a widespread tax evasion. Therefore, while agreeing that there is some room to increase revenues by strengthening tax administration, we share the staff’ view that efforts toward fiscal consolidation should be focused primarily on expenditure prioritization and the pension system reform. Moreover, the financial discipline remains weak, especially of the SOEs, and the issue of domestic arrears is far from its resolution. Urgent measures to improve financial discipline are required to break the vicious circle of arrears.

The recent conduct of the monetary policy has been adequate and characterized by a significant tightening. However, this didn't bring a desirable reduction in inflation, which, in addition to the sharp real depreciation in early 1999, was pushed upward by an inappropriate wage growth and the unresolved problem of domestic arrears. We agree with the staff that the current monetary policy framework is broadly adequate, while actions on the fiscal front as well as an improvement in financial discipline are needed to address the problem of inflation. As for the role of monetary policy itself in the disinflation process, we think that explicit targeting of the exchange rate combined with the adequate fiscal adjustment and strong financial discipline may help stabilize prices and reduce inflationary expectations. At the same time, inflation targeting may be a more challenging task for the authorities at this stage than the exchange rate targeting. In the paper, the staff did not reveal explicitly his preferences for either of these options. Like Mr. Szczuka, we wonder whether this can be done today.

The health of the banking system is a key factor for re-establishing confidence in the Romanian economy. Here, we would like to praise the authorities for the measures that have been implemented so far to deal with problems in the banking sector. The banking reform undertaken by the authorities has allowed them to reduce considerably the share of state-owned banks, to strengthen banking regulation and supervision and to deal decisively with problem banks. However, as the staff points out, the banking system remains fragile. Further improvements are needed in legal and regulatory framework, as well as in the accounting system. Privatization and restructuring efforts should be accelerated especially with regard to remaining state-owned problem banks, such as Banca Agricola (BA) and Romanian Commercial Bank (BCR). It would be helpful to get more information on the strategy used by the authorities with respect to these two banks, since their privatization is significantly behind the schedule. More specifically, we would be interested to find out whether the problems in dealing with these two banks are owing to the influence of vested interests or to the lack of investors willing to buy them.

Over the recent years, Romania has achieved commendable results in privatization. However, the share of large companies under state control remains very high, which is unhelpful for economic efficiency and financial discipline. After some positive steps made since late 1998, the privatization has slowed down in the light of increasing political uncertainties prior to the elections. Moreover, there was information in the press on some irregularities in the privatization of the Romanian State Telecom Company (sold in 1998), and the state tobacco company. Like staff, we believe that progress in privatization is critically needed, and urge the authorities to accelerate their efforts and proceed expeditiously and transparently with the privatization agenda.

With these remarks we wish the authorities every success.

Mr. Kranen made the following statement:

I would like to thank staff for its in-depth and complete preparation of today's meeting. Although I have to admit that I have not studied every one of the 222 pages of the selected issues paper, I would like to state at the outset that we generally share the views expressed in the staff appraisal.

It is indeed regrettable that Romania has fallen behind in the group of transition countries, more than ten years after the breakup of the former East European central planning economies. This year the inflation rate has continued at more than 45 percent. The GDP per capita is, at less than US$2000, the lowest in the group. Although the external borrowing is not particular worrisome, the fiscal deficit remains high and has not improved during the last few years. I agree with staff's characterization that the last decade was driven more or less by a stop and go policy without a clear overall concept.

Given the possible achievements proven in other countries, it might be appropriate to characterize the last ten years as a decade of lost opportunities.

It is particularly disappointing that the positive momentum gained since the new IMF-supported Stand-By Arrangement was adapted has been disrupted in the run-up to the elections. The program is off-track and the second review could not be concluded.

Against this background, I will confine my remarks to two points to highlight the daunting challenges the authorities are facing, namely, achieving macroeconomic stability and speeding up the transition process by strengthening the institutional framework.

Regarding the macroeconomic stabilization task, it is clear that the fight against inflation should be at the top of the agenda. Only a joint effort in monetary, fiscal and income policy, combined with structural reforms in the enterprise sector will lead to lasting stabilization. Although the fiscal stance has shown some improvement in the last year, I agree with Mr. Shaalan and Mr. Himani that the coming budget should be further tightened. In the field of public expenditures there are severe shortfalls in control mechanism. Furthermore, revenue collection should be improved and tax-loopholes as well as tax evasion should be addressed. These measures should be accompanied by a predictable transparent income-policy. Wage increases in the state sector shortly after the first Stand-By Arrangement review was completed, which have far exceed the program levels, are clearly not the right kind of measures needed. Regarding the conduct of monetary policy, we do not see an alternative to the tight stance of the NBR. The further sterilization of foreign exchange inflows is inevitable. Staff remarks that the Central Bank has unduly pursued a relaxed policy given the pressure to lower interest costs for the budget raises the question whether the Central Bank is sufficiently independent.

Coming to my second point, I would like to emphasize the need for accelerated structural reforms. The fact that 80 percent of all enterprises are still under state control proves dramatically that progress in the field of privatization is clearly unsatisfactory. We join staff in its urging to accelerate the privatization efforts and to implement the related World Bank program. Here the authorities can prove their commitment to a market oriented reform approach. Also, in the banking sector much remains to be done. It appears that existing problems are hidden in the fog of inaccurate accounting practices. The privatization of major state owned banks has often been postponed and is overdue.

The lackluster appearance of the institutional framework has also had severe impacts on foreign direct investments which have reached a new low this year. In the first seven months the inflow was only at barely $70 million, compared with more than $700 million in the peak year of 1996. Prominent German companies are currently disinvesting and terminating existing joint ventures. This unfortunate development, which also set a negative signal for other foreign investors, is mainly due to the unfavorable investment environment and governance problems. On the latter I fully share the recommendations expressed by Ms. Lundsager.

Finally, I would like to wish Romania all the best in their future efforts. The country has all chances to make fast progress in the EU-accession track, if the authorities eventually take advantage of the enormous potential of the people of Romania by providing a sound policy framework.

Mr. Xu made the following statement:

We thank staff for the well-balanced set of papers and we also thank Mr. Wijnholds for his comprehensive statement. As we are in broad agreement with the thrust of the staff report, we would like to focus our remarks on the following aspects.

First, on the overall assessment of the economic developments in Romania over the past two years under review, particularly since the Fund program last year, we concur with Mr. Shaalan that the outcomes are mixed. We wish to emphasize that a great deal has been achieved by the authorities under difficult situations over the past two years, and quite a good performance has been recorded in a number of important areas including disinflation, efforts to bring down the fiscal deficit, and improved current account positions. Looking ahead, much needs to be done in macroeconomic stabilization to place the economy on a sustainable growth path. Therefore, the authorities are encouraged to move ahead with reform program to realize the potentials of Romania.

Second, though inflation has declined significantly over the past two years, the latest inflation of around 43 percent is still quite high by any standards. Being fully aware of the destructive impact of high inflation, the authorities now have the task of reducing inflation as the most important task on their agenda, and as their long-term sustainability and strategic objective, in particular in the context of access to a full EU membership. Under this background, we concur with the authorities that a lasting success in disinflation in Romania can only be materialized by supplementing monetary policy with greater support from income and fiscal policies, and by a substantial improvement in financial discipline in the enterprise sector. In fact, the authorities have made some progress in this direction.

Finally, we take note of the fact that the authorities decided to recapitalize the Bank Agricola rather than its liquidation as previously committed. We also note the undue delays recently occurred in the privatization and resolution of stated-owned banks. It seems to us that the authorities have reasonably committed to banking restructuring: i.e., unsound banks were closed down and constant efforts have been made to reinforce the regulatory and supervisory functions of the central bank. That being said, in our view, privatization might be overemphasized and we probably need to take a more balanced approach toward banking privatization for a sustainable banking system. Staff comments are welcome.

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

Mr. Whitehall made the following statement:

Romania is a country in transition which continues to struggle with a number of unfortunate difficulties related to past regimes. The reform effort appears to have slowed considerably in recent years and a major effort is needed if Romania is to catch up with other similar economies in transition and support its accession to the European Union. Some progress has been achieved over the last two years under difficult circumstances and the run-up to the elections. Notably, there has been some improvement in banking reform, but we concur with other speakers that the banking system continues to face confidence issues and the authorities need to redouble their efforts. We also note the improvement in import cover which has reached 2.7 months during the first eight months of 2000.

Staff has indicated that the authorities are indeed mindful of the need for both stabilization and structural reform. However, the process toward reform continues to be hindered by policy slippages. These include the servicing of domestic arrears, inconsistencies in monetary policy, and the difficulty of sustaining a coherent policy on the size and remuneration of labor in the public sector. Specifically, in the area of monetary policy we note the inherent inconsistency of targeting both the level of inflation and the level of the exchange rate.

We urge the authorities in Romania to learn from the example of other countries in transition by accelerating the pace of structural reform. In particular, it is important to facilitate the development of a vibrant private sector by removing any remaining legal or administrative obstacles. With these words of caution, we wish to encourage the authorities to persevere in their efforts to maintain the momentum of structural reform.

Mr. Al Azzaz made the following statement:

Romania's economic situation remains fragile and progress has been weak on most fronts. The slow pace of adjustment and reform needs to be replaced by strong and sustained policy implementation.

Greater fiscal discipline is critical to help reduce inflation in order not to overburden policy. Streamlining [tax administration??] and increasing revenue collection should be at the forefront. On the expenditure side, it is important to review structural expenditures, including targeting of social benefits, overstaffing, and reform of the pension system. It is also important to contain wages and strengthen governance in state-controlled companies.

On the structural front, the authorities clearly need to accelerate enterprise privatization in order to enhance economic efficiency and maintain financial discipline. Steps are needed in the privatization of state-owned enterprises and the promotion of an environment conducive to business.

As other speakers have noted, reform of the banking sector is another area that requires further attention. Although some progress has been made in restructuring this sector, additional efforts are needed to strengthen the legal, regulatory, and supervisory frameworks. Privatization of the remaining state-owned banks and improved governance in the financial sector are also crucial.

Mr. Kpetigo made the following statement:

I would like to associate myself with previous speakers in welcoming the progress that the authorities have made. Like Mrs. Steinbuka, Mr. Vittas, and others, I encourage them to stress structural reform, particularly in the banking sector and to press ahead with the privatization process in all sectors.

The staff representative from the European I Department noted that the inflation target for 2001 was 27 percent, which represented a halving of the inflation rate from the preceding year. The staff had included such an ambitious target because the inflation rate had been high the preceding year owing to the large corrective exchange rate depreciation that had occurred.

The drought and the value-added tax were expected to cause an increase in food prices of about 5 percent, the staff representative remarked. Fuel prices however had not contributed to the rise in inflation because excises had been linked to the euro, which had depreciated sharply against the dollar. Nevertheless, fuel prices had risen faster than the CPI the preceding year owing to the depreciation of the exchange rate.

Even though the performance criterion for wages had been met in end-June, increases in wages had contributed to rising inflation as the inflation target had been set in late 1999, the staff representative explained. The end-June targets had been set after there had already been some slippages in the level of nominal wages.

Estimates as to the size of the 'black' economy varied from 20 to 40 percent of the economy, the staff representative noted. The major tax reform of 2000 was a step in the right direction to address that problem, evidenced by the increase in revenues in 2000.

The Fund decision not to require the authorities to restructure or default on their debt obligations in May/June 1999 had been appropriate, the staff representative said. The authorities' ability to service their debt promptly was an important factor behind their reentry into capital markets, most recently in the amount of $300 million.

The staff and the authorities had discussed the monetary framework, and had agreed that exchange rate targeting would be preferable to inflation targeting, the staff representative commented. However, it seemed premature to have a detailed discussion of that issue in the staff report as it could appear that the authorities were prepared to move in that direction soon, which they were not. Quite a lot remained to be done in terms of enhancing financial discipline and strengthening the fiscal position before the authorities could adopt a more explicit monetary framework.

Mr. Wijnholds made the following concluding statement:

This was a useful discussion. The messages that I heard from Board members are particularly good for the new government and, therefore, the Press Information Notice will be a very useful document for them, and I will highly recommend that they read it carefully.

As you are aware, Romania has just had an election, and there is going to be a run-off in the presidential race, with Mr. Iliescu, a former President, being ahead, but with an institutionalist candidate, Mr. Tudor, doing much better than expected and causing some concern, which is understandable. Perhaps we should recognize here that there is a certain [fatigue??] among Romanians with the economic situation, and under those conditions sometimes electorates go a little bit too extreme. We should therefore not read too much into this outcome. In any event, the winner of the elections, the PDSR, did not gain an outright majority, but received about 38 percent of the vote, which means it will have to form a coalition. Coalition partners are likely to come from parties that constituted the present coalition. They, of course, will be junior partners, but they will have some leverage and should be able to impart something of a moderating influence. Some of the pronouncements that have been made by Mr. Iliescu recently have to be seen largely in the light of the electoral process. We have had some experience with a government led by him in the past, and in the end he might turn out to be more pragmatic than many people would have expected, but that remains to be seen.

The prospect for dialogue with the new government is quite good. The government will fully realize that it has little choice but to have such a dialogue, and that it is in its own interest, particularly also with a view to the European Union accession process. The accession process is a very, very strong force in countries in that part of the world; they certainly have a strong desire to move in that direction. Whether this will soon lead to a new program remains to be seen, but, as was remarked by the staff representative from the European I Department, the European Union has specifically made the recommendation that Romania work closely with the Fund. Therefore, I believe that there will be new attempts and we hope for the best.

There were a few interesting points that I would just briefly want to touch on. One matter that got quite a bit of attention was the monetary regime and the exchange rate regime. The staff was right in not going into this very deeply at this point, because it would indeed be somewhat premature. I mentioned in my statement that the present authorities and certainly the National Bank share the view that a move toward a fixed exchange rate or inflation targeting should not come until wage growth has come under better control and financial discipline has been improved significantly.

I recall that a number of years ago in this Board we had a discussion at a time when Romania had a much more fixed regime and Directors said that it may be wise to move to a flexible regime, which is indeed what they have done. One has to be very careful with that given what we have recently seen in some larger emerging market economies with more fixed regimes getting into a crisis partly because of that regime.

> Finally, perhaps a word on the position of the National Bank of Romania. It is certainly not as independent as the Bundesbank before the advent of the European Central Bank; I do not think anybody could expect that. Such independence is something to strive for as they move toward Europe more closely. I want to say that within the Romanian context the National Bank is a very, very important institution. It is quite an effective institution, which one cannot, unfortunately, say for all other institutions in the country. It has been a very positive factor in the discussion with the Fund, and I certainly have very good contacts there. Anything that we can do to help strengthen their independence would be very welcome.

Mr. Szczuka noted that he was not suggesting that the authorities necessarily adopt a fixed exchange rate regime.

The Acting Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They were encouraged by Romania's significant progress in stabilization and reform since the completion of the previous Article IV consultation in September 1998. Directors commended the authorities for their decisive steps to stabilize the economy, including a significant fiscal adjustment, which, together with the depreciation of the exchange rate in 1999, had helped narrow the current account deficit to a sustainable level and averted an imminent financial crisis. They also welcomed the measures taken to restructure the banking system and the initial acceleration in enterprise privatization after a long period of neglect.
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> Directors expressed concern that more recent developments risk putting in jeopardy the good performance achieved in the last two years. They regretted Romania's lack of success in reducing domestic arrears and the policy slippages that had occurred in the area of state sector wages.
>
> Directors observed that Romania's stabilization and reform efforts still lag behind those of most other transition countries in Central and Eastern Europe, reflecting mainly the "stop-and-go" approach to reform and macroeconomic stability pursued for much of the past 11 years. They therefore urged the authorities to break decisively with the previous pattern of policymaking and to engage in a sustained and vigorous strategy of stabilization and structural reform, so as to at last achieve a sustainable improvement in living standards and improve prospects for a smooth integration into the European Union.
>
> Directors considered that progress in disinflation and strengthening the external position in Romania will require continued fiscal consolidation combined with the pursuit of a prudent monetary policy as well as wage and financial discipline in the state-owned enterprises. Given that most large

companies still remain under state control and suffer from weak corporate governance, they stressed the critical importance of controlling wage costs in these companies and of intensifying efforts to reduce domestic arrears. In order to enhance economic efficiency, the above policies will need to be accompanied by strong reform measures, including accelerated restructuring of the enterprise and banking sectors and an improvement in the business environment.

While welcoming the narrowing of the budget deficit in recent years, Directors cautioned that the fiscal position remains precarious and will need to be strengthened to achieve stabilization. They urged the authorities to treat their medium-term fiscal deficit target of 3 percent of GDP as an upper limit. Directors expressed concern that recent changes in the structure of public expenditure—involving significant real expenditure increases on personnel and transfers and subsidies—were steps in the wrong direction, marking a relaxation of fiscal policy. In addition, they noted that the budget will come under increasing pressure in the coming years owing to additional claims stemming from the EU accession process and the accelerated restructuring of the economy. Against this background, Directors considered it urgent for Romania to reform government expenditure and the pension system through improved targeting of social spending, reduction of excess staffing, and further tightening of the eligibility requirements for pensions. They noted that these issues will be addressed extensively at an early date in the context of a Public Expenditure Review to be conducted with World Bank assistance.

Directors emphasized the importance of a prudent monetary policy, along with financial discipline for the budget and state-owned companies, in reducing inflation and containing the growth in domestic demand. They considered the current level of external competitiveness to be adequate. On the monetary policy framework, Directors noted that the managed float aims at striking a balance between inflation and external objectives. Looking forward, they agreed that a more transparent monetary policy framework—involving an explicit target for the exchange rate or inflation—could facilitate disinflation. However, implementation of such a framework will require improved financial discipline and fiscal reform.

Directors welcomed the authorities' efforts with regard to bank restructuring in the last two years, but noted that a great deal remains to be done, as underscored by the lingering presence of unresolved problem banks in the system and the continuing appearance of new cases. Besides a stable macroeconomic environment, the creation of an efficient and healthier banking system will require privatization of the banks remaining under state control through transparent procedures aimed at enhancing the prospects for their sound management. In this context, Directors regretted the authorities' decision to recapitalize Banca Agricola in the absence of firm prospects for its privatization. They also noted that recent events in the banking system underscore the urgency of further enhancing the legal and regulatory framework as well as improving supervisory practices and regulations. Directors pointed out that the circumstances of the collapse of a mutual fund earlier this year had highlighted serious weaknesses in the regulation and supervision of the nonbank financial sector as well as broader governance problems. They called on the authorities to hold those involved accountable and to proceed expeditiously with the required institutional reforms in this area.

Directors reiterated that progress in enterprise privatization is key to enhancing financial discipline as well as efficiency. They considered that, with 80 percent of pre-transition state-owned large companies still remaining under state control, the authorities face a considerable task, but that the gains from the success of privatization and the restructuring of these companies could be very large. In this regard, Directors urged the authorities to proceed expeditiously with the privatization of the 63 large commercial enterprises on the basis of the transparent procedures envisaged under the World Bank's Private Sector Adjustment Loan. They also advised the authorities to prepare the privatization of the national companies (former régies autonomes), which should contribute significantly to economic efficiency and financial discipline owing to their pervasive role in the economy and their financing of domestic arrears.

Directors observed that Romania's statistical base is of adequate quality, but encouraged the authorities to make further improvements, in particular with regard to balance of payments data and the consistency of fiscal and monetary data.

Directors noted that the discussion on policies for the second review of the Stand-By Arrangement with Romania was not concluded. They hoped that the authorities would soon commit to a comprehensive set of measures for stabilization and structural reform.

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

2. PAKISTAN—2000 ARTICLE IV CONSULTATION; AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 2000 Article IV consultation with Pakistan and its request for a Stand-By Arrangement (EBS/00/230, 11/15/00; Sup. 1, 11/20/00; Sup. 1, Rev. 1, 11/28/00; and Sup. 2, 11/28/00). They also had before them a background paper on selected issues and a statistical appendix (SM/00/261, 11/20/00); and Pakistan's report on observance of standards and codes—fiscal transparency module (SM/00/264, 11/28/00).

Mr. Mirakhor submitted the following statement:

My Pakistan authorities express their appreciation to staff and management for their advice, guidance and support during intensive discussions spread over the past several months. Staff have worked with great dedication and a high level of professionalism and have written a clear and insightful report which my authorities will publish. My authorities agree with the broad thrust of the staff's policy analysis and recommendations. The high quality of technical assistance provided by the Fund to Pakistan in various fields is also deeply appreciated.

Despite the conjuncture of adverse developments—the sharp rise in world oil prices and the virtual absence of financing from IFIs—Pakistan's economy performed reasonably well in 1999/2000 in terms of growth, external adjustment and structural reforms. Economic growth, at close to 5 percent, was favorable, led by the robust expansion of the agriculture sector (7 percent) with excellent cotton and wheat harvests. While good weather no doubt helped, the growth in agriculture was also due to a series of decontrol measures. Excluding the sharp fall in sugar production, output in the large-scale manufacturing sector rose by close to 6 percent with the textiles sector showing particular strength. Consumer price inflation, at below 4 percent annual average rate, was the lowest for several decades, reflecting the stability of the exchange rate, some decline in non-oil commodity prices, and ample domestic supplies. There was a major reduction in the external current account deficit thanks to higher exports and workers' remittances and despite a severe terms of trade loss. However, the absence of normal external inflows and cautious investor sentiment inevitably took its toll and led to pressures on Pakistan's gross official reserves. Despite this difficult situation and the pall of uncertainty that hung over the economy in the absence of official external support, the authorities implemented a number of important structural reforms—which are detailed in their MEFP—in the fiscal, financial, external trade, energy and public enterprise sectors.

In their discussions with staff, the authorities recognized that the challenges facing Pakistan were twofold: first, given the fragile nature of the present economic situation, to take measures to achieve rapid and convincing stabilization; second, to press ahead with a broad range of structural policy reforms which would encompass all sectors of the economy so as to lay the basis for a resumption of high-quality sustainable growth and poverty alleviation over the medium-term. Their 2000/01 program of stabilization and reform, in support of which they are requesting a Stand-By Arrangement with the Fund, is anchored on these two pillars. Macroeconomic policies have been tightened, there has been a sizeable up-front exchange rate action, all prior actions for the Stand-By Arrangement have been completed, and a comprehensive program of structural reforms aimed at enhancing the economy's efficiency and competitiveness has been put in place.

At the heart of the adjustment effort is a commitment to sharply reduce the budget deficit to attenuate demand pressures while implementing a number of fiscal structural reforms so that the process of fiscal consolidation can be put on a durable track. These reforms include measures to increase tax collection, widen the tax base, and contain current expenditures. At the same time, mindful of Pakistan's large unmet development needs, the authorities have significantly enhanced allocations for development and poverty-related expenditures. Key steps have been taken to strengthen tax administration and taxpayer registration. The authorities have launched an unprecedented countrywide tax survey and registration drive that promises to provide a major boost to both tax revenues and registration over the medium-term. The GST has been widened to include the services sector and will be extended to the retail stage and agricultural inputs; the taxation of agriculture incomes has been given credence by the introduction of a two-tier tax; a fundamental overhaul of the income tax system, based on universal principles of self-assessment and audit, is underway; and GST, customs duty and income tax exemptions are being withdrawn. The authorities acknowledge that the full benefit of these reforms will be felt gradually. Accordingly, cushions have been built into the budgetary projections so as to safeguard the deficit target.

Monetary policy has been tightened in support of the shift to a more flexible exchange rate regime and with a view to keeping inflationary pressures at bay. In regards to the exchange rate regime, the authorities recognize that the vulnerability of Pakistan's balance of payments, it's large financing requirements, and the envisaged trade reforms will require greater exchange rate flexibility. In this context, they are committed to enhancing the role of market forces in line with the recommendations of a recent MAE technical assistance mission. There is an impressive list of structural reforms being implemented in the financial sector. Particularly noteworthy are: reducing financial market segmentation through rationalization of the National Savings Schemes (NSS); narrowing, and eventually eliminating, the export subsidy element of the export finance scheme, liberalizing rules governing new foreign currency deposits, the establishment of the Corporate and Industrial Restructuring Corporation (CIRC), and the launching of an ambitious drive to privatize banks and restructure and consolidate development finance institutions, with a view to their eventual privatization. The authorities have requested participation in a FSAP which will guide future reforms in the financial sector.

Public enterprise reform remains the key to raising economy-wide efficiency and reducing enterprises' burden on the budget. In this context, reforms in the power sector with the assistance of the World Bank and AsDB will focus on enhancing performance of the two major enterprises—the Water and Power Development Authority (WAPDA) and Karachi Electric Supply Corporation (KESC). With the World Bank acting as facilitator, the authorities are making hectic efforts to bring the long-standing dispute with HUBCO to an end. A medium-term trade liberalization program centered on a pre-announced reduction in the maximum tariff rate and in the number of tariff slabs is in place. In addition to the privatization initiatives in the banking sector noted above, the government has launched a comprehensive privatization program to be implemented in the short and medium term and covers the telecom, oil and gas, power, industry, infrastructure, aviation and insurance sectors.

Improving governance and enhancing transparency are important adjuncts to the government's overall reform agenda. The staff report notes the number of concrete steps that have been taken in furtherance of these objectives. These include the National Devolution Plan, a program to improve economic governance through greater accountability of public officials, reforms of the civil service, police and judiciary, and, in the all-important fiscal sphere, participation in the fiscal module of the ROSC. In addition, the authorities have taken a number of steps to strengthen the quality and transparency of public accounts in line with the recommendations of an FAD technical assistance mission on fiscal reporting issues. They realize that extreme vigilance over reporting and reconciliation issues will be needed to preclude a recurrence of discrepancies in the reporting of fiscal data. An action plan to improve the quality and frequency of national accounts data has also been adopted.

Notwithstanding the strength of the adjustment effort and the breadth of these macroeconomic, structural and institutional reforms, Pakistan's external financing needs in 2000/01 will be significant with staff estimating a gross exceptional financing requirement of about US$4 billion. This will require significant support from the private sector, the IFIs, and bilateral sources with the remaining financing gap being closed by a rescheduling of debt to Paris Club and other bilateral and commercial creditors. The staff report highlights the risks that any shortfalls in financing would pose for the program's objectives. It is clear that adequate and timely financial support from the international community, along with the confidence-enhancing effects that this support will engender, will be critical determinants of the success of the authorities' stabilization and reform program.

My Pakistan authorities wish to convey to the Executive Board that they view the requested Stand-By Arrangement as only a first step on a long and arduous road of economic adjustment and reform. They recognize that Pakistan faces many challenges and that while the present program is strong with a solid structural content and represents a good start, much remains to be done. Accordingly, it is their intention to transit, at an appropriate time, to a multi-year PRGF which would provide a better framework within which their growth-enhancing reform agenda can be implemented.

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

Pakistan is an economy whose potential is high, but where considerable stabilization and reform measures are needed. Over the past decade or two, the authorities have made several attempts at introducing comprehensive reform programs. Unfortunately, for the most part these attempts have been frustrated by domestic or external developments. More recently, the overall macroeconomic outlook deteriorated, due to a weakening in the fiscal position combined with a loosening of monetary conditions. In response, the authorities have undertaken corrective measures which provide an encouraging basis for the current program.

The program before us is adequately broad based, and incorporates the elements necessary to restore macroeconomic stability. The fiscal position will be significantly strengthened. A pragmatic and market oriented exchange rate policy will be pursued, while significant inroads in liberalizing the economy are expected. The success of the program depends in significant part on the restoration of investor confidence, which in itself takes time to build. Thus, the authorities need to remain steadfast in the implementation of difficult measures where the results will not be immediately apparent.

For decades fiscal policy has been the Achilles' heel of the economy, and is appropriately the center piece of the current program. The envisaged consolidation of about 1.3 percent of GDP during the current fiscal year is a significant start. Given the very low level of expenditures to GDP, a durable and credible consolidation process can only be complete with the introduction of ambitious reforms to the revenue system and tax administration. From this perspective, we find the program to be well thought out. Measures to improve tax administration are being implemented, the sales tax coverage has been extended and enhanced enforcement of the GST is foreseen. The authorities have also undertaken to extend the GST to agricultural inputs. Particularly crucial to the success of the fiscal agenda are measures aimed at preventing a loss of discipline at the provincial level.

Consistent implementation of the totality of the envisaged fiscal measures will be key to the success of this program, particularly when seen against the background of past slippages in fiscal policy. Given the need to restore credibility expeditiously, any policy slippages at this time, even if minor, could well have a considerable impact on the program as a whole. Furthermore, a sustained fiscal consolidation effort is a prerequisite to creating the conditions necessary for monetary and exchange rate stability.

As staff point out, exchange rate and monetary policies are crucial elements of the stabilization program in the near term. At the same time, these are areas where considerable risks lie, and the authorities need to walk a very fine line between allowing a greater role for market forces in the foreign exchange market, and maintaining monetary stability in an environment of highly uncertain money demand. The authorities' ability to reconcile these objectives will certainly be tested, and a choice will be necessary at times. In the near term, given the very low level of reserves, the authorities would be well advised to allow the exchange rate to respond to market forces. Looking ahead, however, as the fiscal consolidation and reform efforts take hold, and reserves are built up, a higher emphasis on stability in exchange rate management may better serve the authorities' medium-term needs.

Turning to structural reform, the agenda facing the authorities is extensive. Early progress in public enterprise reform is necessary for both efficiency and fiscal reasons. Trade reform should help create a more competitive domestic environment. The early resolution of the tariff dispute with IPPs will contribute to improved investor sentiment. While all measures being considered are important, some greater prioritization may be needed when formulating the authorities agenda in the future. The medium-term implication of failing to meet an overly-ambitious agenda should not be underestimated. It will likely be better serve Pakistan to aim at exceeding a more modest structural program.

Looking to the future, success in the stabilization efforts underway should pave the way for a comprehensive medium-term program that can be supported by the PRGF. We wish the authorities every success in the period ahead.

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

General remarks

The delay in the Article VI consultation with Pakistan and the initiation of a new program resulted in a set of rather extensive staff papers this time around. We want to commend the staff on the work well done in preparing these papers.

We welcome the new arrangement for Pakistan. The commitment of a new government to make a clear break from the past has been evident from the reforms undertaken throughout the last year in various areas of the economy, as well as by all prior actions being implemented before this review. The country's current economic situation most definitely necessitates the assistance from external parties. With a continuing pressure on the rupee, a dangerously low level of foreign reserves and raising public indebtedness, Pakistan is walking on a thin ice. However, obtaining interim external financing and debt service restructuring will not help resolve the country's problems unless deep and wide-ranging reforms actually take place.

We support the program, but not without reservations. Indeed, the country's track record is not very convincing. Policy implementation and economic performance has been week in the past, leading to a significant deterioration of economic and social indicators. Nonetheless, the staff make a good case of presenting strengths and potential benefits of the proposed reform program while still being very frank about the underlying risks. We generally agree with the staff appraisal but will offer some remarks.

Exchange rate

Previously we welcomed the unification of the official and interbank exchange rates, while indicating that maintenance of the established floating exchange rate regime would be one of the key indicators of the country's economic progress. At present, we are a bit concerned that notwithstanding some depreciation of the rupee that took place the authorities seem to have tried to keep the exchange rate constant, which is evident from a persistent difference between the official rate and a more depreciated kerb market rate, the authorities' interventions in the forwards market and a subsequent loss of reserves. While the authorities indicated that they would not engage in outright forward transactions once the program was approved, we wonder if there is a need for a safeguard in this area in a way of setting a quantitative performance criterion on stock of foreign exchange swaps rather than it being only an indicative target. For example, according to footnote 16, the SBP's outstanding short-term swap and outright forward commitments amounted to US$175 million as of mid-October 2000, which is 20 percent of net official reserves and is quite a significant amount under the current circumstances. In any event, given a great necessity to build-up foreign reserves, we strongly urge the authorities to avoid outright forward transactions by the SBP and limit interventions in the foreign exchange market only to smoothing out fluctuations resulting from lumpy transactions.

Fiscal situation

It is clear that success or failure of the program will heavily depend on the performance in the fiscal area. To a large extent this has been the weakest part of previous programs and continues to be one of great concern. However, recently much has been done to reverse this trend. We welcome the efforts made by the authorities in this area as well as their commitments under the program as described in a five page long section of the staff report. Nonetheless, the situation remains fragile, with tax performance in the first quarter being slightly weaker than envisaged. While there are contingency measures in place in case the deficit is above the target, all efforts should be made to resist expenditure cuts, especially within the Public Sector Development Program. In this vein, improving tax performance should be the authorities' major priority, especially through extension of the GST to services and agricultural sector and enforcement of the GST in the retail sector. Structural reforms in the tax area are also important but these will take time and, thus, generate the income only at a later stage.

Given the fragility of the fiscal situation, we are somewhat concerned about the effects of too rapid trade liberalization reforms on the budget. At previous occasions we noted that given the history of continuing shortfalls in revenue collection, forsaking foreign trade tax revenues and relying heavily on improvements in other areas of tax collection, may be a rather risky step. We would welcome the staff views on this issue.

Structural reforms

We believe that structural reforms envisaged under the program are broadly appropriate, and so is the list of structural performance criteria. We have a question, however, regarding the two structural criteria that were part of the past program but are not included in the present list of performance criteria. According to pages 60-61 of EBS/99/72 these are: 1) "harmonizing provincial taxation of agricultural income..." and 2) "elimination of electricity subsidy for all households." Could the staff clarify why these were a part of the last program but not of this one. In the same vein, we wonder why several previously set structural benchmarks relating to privatization and financial sector issues were not included in a new list of structural benchmarks.

As we have stated previously, high reliance on taxation of the energy sector is a cause for concern. There is always a possibility of a supply shock if prices increase drastically in accordance with the automatic price adjustment mechanism and in light of a current high international price level. This can easily lead to social tensions as well as hamper growth prospects. This time around we were glad to find some coverage of this topic in the Selected Issues paper. However, the staff argue that more fundamental change needs to take place in petroleum pricing mostly because of the unstable nature of petroleum tax revenues rather than because of the aforementioned concerns. While we agree with the staff, we believe that speeding up the medium-term oriented structural reforms should be supplemented by shifting the emphasis to other sources of revenue in the short run.

Financial Sector challenges

We are glad to see that financial sector reforms are in progress, especially the rationalization of the National Savings Scheme, the narrowing of the subsidy element of the Export Finance Scheme and the envisaged liberalization of the rules governing new foreign currency deposits. We also note the measures being taken to enhance the commercial liberalization of the banking system as well as the fact that preparations are underway for a conversion to implement the Islamic Banking principles. The latter raises a lot of issues that were not covered in the papers. External sources report that outside of Pakistan there is a lot of anxiety within investor community over this conversion. For example, it is said that one of the central outcomes of this conversion will be ending of the practice of banks charging borrowers a pre-determined interest rate or paying an interest to depositors. Several other issues catch attention, such as, what would be the consequences of the transition given the current turbulent economic environment? How would interest rates be used as a monetary policy tool under the new system? How would the credit extension to private sector be affected? Given the importance of this issue, it would have been very useful to have an analysis of this transition in the papers. A broader coverage of this issue is warranted in the future.

Statistical issues

We are pleased to see an extensive description of statistical issues in the main paper. This is quite appropriate given the past history of misreporting. We welcome the work that is being done by the authorities in strengthening the systems of public and national accounts, and the external debt database as described in Appendix VI. We urge the authorities to make best effort to improve these systems expeditiously. However, given that fiscal accounts have always been a weak area and that the program depends so heavily on meeting fiscal targets, it is quite worrisome that the staff believe that data continue to be "particularly weak in the fiscal accounts." Frankly, we did not find the staff to be very reassuring on this issue at all. Are the staff overly cautious when putting a rather strong disclaimer (para 59) about the still serious data weaknesses? In the staff view, is enough being done to improve the situation? Also, there is a concern that the safeguards in place at the SBP "may not be adequate" to manage resources, including the Fund disbursements. While we anticipate the conclusion of stage two of the assessment, we urge the authorities to be most cooperative in this area.

Finally we support the proposed decision and wish the authorities success.

Mr. Yoshimura and Ms. Saito submitted the following statement:

Introduction

I would first like to commend the dedicated efforts of staff and the authorities in putting together this program after the EFF-supported program went off track in May 1999. This chair agrees with staff that what Pakistan most needs to do now is to implement a number of stabilization measures. We welcome the various prior actions that the authorities have implemented, as mentioned in Mr. Mirakhor's extensive Preliminary statement. This shows their determination to implement the program and will send a positive message to the outside world. That said, this program has been intricately designed to implement a sizable number of policies within a short period of time, and this will necessitate even stronger ownership on the part of the authorities since if the policies are not implemented within the time frame it could have a destabilizing effect on the economy. In this respect, I hope the authorities will be able to maintain the momentum of reform. There are a couple of areas that I believe are particularly important in implementing the program.

Fiscal issues

On the fiscal front, there is an immediate need to secure revenue through improved tax collection, and we welcome the extension of the GST to petroleum products, natural gas, and electricity. However, it concerns me that the GST is yet to be seen in the retail sector and there is a delay in introducing it in the agricultural sector. The authorities have also been slow in the process of registering large taxpayers. Reform in this area has only just started, and we urge the authorities to persevere in their efforts—especially the agricultural sector, since this has been most resistant to change. It is noteworthy that the authorities have introduced measures to monitor expenditures in order to make them more effective and efficient. While we welcome these measures, expenditure control is no substitute for revenue strengthening. With respect to revenue strengthening measures, we feel that the limited institutional capacity of the CBR may be hindering effective revenue collection. In this respect, we would like to ask staff about any discussions that have taken place on capacity building in the CBR. Paragraph 75 of the staff paper mentions the importance of monitoring the slippage on the budget deficit. However, as slippages on the budget deficit are more likely to occur because of ineffective revenue collection than because of expenditure expansion we would like to ask staff to confirm what contingency measures are available in the event of a slippage due to a failure in revenue collection.

Restructuring of state-owned enterprises

We welcome the restructuring of state-owned enterprises such as WAPDA and KESC with the assistance of the ADB and the World Bank. We understand that the financial viability of these enterprises is being improved by raising tariffs, and this is important from the standpoint of reducing the heavy burden of these corporations on the budget. At the same time, we would like to stress the importance of not only restoring the financial viability of these corporations but also of improving their fundamental management structure to make them more efficient. Especially in the case of KESC, improved governance is essential, and we will be watching carefully for signs of improvement.

Monetary and exchange rate policy

On monetary and exchange rate policies, we support the tightening stance to support the transition to a market oriented, flexible exchange rate regime; to quell speculative pressure against the rupee while building up official reserves; and to keep inflation in check. The strengthening of the exchange market will be the key to restoring market confidence, and in this respect we welcome the depreciation of the rupee as a step toward a flexible exchange regime. Removing the requirement of underlying commercial transactions and increasing Nostro limits are welcome steps toward deepening the market. We also welcome the phasing out of foreign exchange purchases in the kerb market and making transactions in the interbank market. On the other hand there is a risk of an attack on the currency following such moves. We would be interested in hearing the staff's view on the desirable pace and modality of market liberalization, taking into consideration such risk. We would also like to know what impact staff think market liberalization would have on the kerb market.

Private capital inflows

As for capital inflows, although in the short term there will be a higher proportion of public funds, in the medium to long term it will be essential to secure private capital inflow in the form of direct investment in order to ensure sustainable economic growth. We share staff's concern that the resolution of the IPP issue is paramount to the success of the program as well as to restoring investor confidence. However, we think that including individual projects as part of the prior action of the program smacks too much of micro-management—although we acknowledge that this issue will be properly addressed in the general discussion on conditionality. Concerning the inflow of private capital, it seems that the staff's perspective on the amount of private capital that will be forthcoming seems overly optimistic; in any event, the authorities need to try even harder to improve the investment environment in areas other than the IPPs. Reforms in the financial, gas, and power sectors will also be important in restoring private investment as foreign investors will be watching the progress of the reform efforts carefully. Although implementation of reforms in these sectors will not be easy to complete in a short amount of time and will surely take longer than the length of the Stand-By Arrangement, it will be important to implement the measures as agreed with the multilateral institutions that are assisting the programs.

Paris Club rescheduling

Given Pakistan's high external vulnerability, staff's assessment that Paris Club rescheduling will play a major part in filling the financing gap seems reasonable. We hope the authorities will engage seriously in negotiations not only with multilateral and bilateral official creditors but also with private creditors. It is of the utmost importance that the authorities demonstrate their credibility by steadily implementing the actions and the conditionality agreed to in the program. On the matter of external financing needs in 2001/02 to 2003/04, it is assumed that even under the medium-term program after the Stand-By Arrangement there will continue to be a large financing gap. This implies that in addition to having to rely excessively on private capital inflows, the authorities will also have to reschedule their debt with the Paris Club and other bilateral creditors. In other words, during the Stand-By Arrangement the financing gap is assumed to be filled by Paris Club rescheduling, and after the Stand-By Arrangement, even if Pakistan can secure a similar amount of multilateral assistance, the authorities will still have to rely on a substantial amount of Paris Club rescheduling to fill the gap. As staff points out in the Selected Issues Paper, Pakistan's debt problems will not be solved in the short term merely by rescheduling but will necessitate implementing medium-term policies such as fostering export growth, restoring confidence of donors and investors, implementing prudent external debt management, improving the expenditure structure, and increasing the primary surplus. This chair believes that it is paramount that Pakistan free itself from continuous rescheduling. It is therefore important that its debt sustainability is secured by the implementation of these longer-term measures, and in this respect we would request staff to carefully monitor the external financing needs in the medium to long term.

Poverty issue

Lastly, considering the depth of Pakistan's poverty, where one-third of the population is below the poverty line, we understand the authorities' request for a PRGF-supported program. We welcome the increase in expenditure for poverty reduction in the latest budget; however, it is essential to have a comprehensive strategy to tackle the issue of poverty reduction, and in this respect we look forward to serious efforts by the authorities to draw up such a plan, taking into consideration the participatory process of civil society. That said, we would like to stress that the authorities' highest priority meanwhile should be to implement the measures in the Stand-By Arrangement aimed at stabilizing the economy and restoring market confidence.

With these remarks, we support the proposed decision.

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

After several decades of political turmoil, decaying economic and social infrastructure, rampant poverty and economic decline, we welcome the authorities' resolve to reverse Pakistan's recent history of economic underachievement and their commitment to ensuring macroeconomic stability. This period is an important one for the authorities to accelerate the pace of reform as there are rising expectations regarding the mitigation of poverty and the provision of an improved level of social services, the fulfillment of which could strengthen the process of political and social stabilization.

In order to ensure price and macroeconomic stability, fiscal policy over the medium term in Pakistan must focus on implementing measures designed to achieve a significant decline in the overall fiscal deficit.. In this context, we note in the MEFP the authorities' intention to implement a series of measures to increase tax collection, including steps to widen the tax base and contain current expenditures to support the fiscal consolidation process. We agree that in strengthening the revenue collection mechanisms, a review of the tax regime should be addressed with the view to enhancing efficiency and establishing a more competitive, transparent, and performance-based structure. While we recognize that more effective expenditure controls are difficult to achieve given Pakistan's circumstances, we note that the authorities have identified contingency measures to compensate for revenue shortfalls. However, we urge them to avoid overruns on the target for defense expenditure. We support the increase in social and poverty-related spending.

With regard to monetary and exchange rate policies, we support the authorities' institution of an appropriate market-based monetary policy and a more market determined exchange rate. We share the staff's concern of the existence of parallel foreign exchange markets and we note the authorities' intention to stop the diversion of current transactions to the kerb market through official actions. With the establishment of a more flexible exchange rate regime and in an environment of relatively low inflation, the authorities could have some leverage to reduce interest rates to provide support for their stated goal of increasing private sector activity. We agree with staff that the critical elements of the stabilization program are exchange rate and monetary policies. External assistance will be required to support both the budget and the external account well into the medium term. In this context, we note that Pakistan's external financing needs in 2000/01 will be significant with staff estimating a gross exceptional financing requirement of approximately US$4 billion.

The authorities' planned implementation of financial sector reform measures to improve the efficiency and competitiveness of the financial system and strengthen bank supervision should also improve the role of banks in providing credit to the private sector. The authorities should continue to adopt measures to improve the functioning of the economy including the acceleration of the privatization program and the opening up of the major sectors to foreign investors, through the creation of an investor-friendly environment in the context of a coordinated medium-term strategy. To maintain the growth momentum over the medium-term, the authorities will need to undertake a comprehensive structural reform effort aimed at further strengthening efficiency and productivity.

With regard to the discovery of discrepancies in the fiscal accounts in 1993/94—1996/97, and late 1999, we welcome the measures put in place by the authorities to improve financial management and to enhance the transparency of economic and financial policies and data, including the establishment of the Fiscal Monitoring Committee and the Pakistan Improvement of Financial Reporting and Accounting.

The challenges that Pakistan faces are to advance its structural reform program and to promote the growth of the private sector. Of critical importance is Pakistan's need to adopt appropriate and viable social safety nets to reach the more vulnerable in society and reduce the incidence of poverty. We welcome the authorities' strong commitment on establishing good governance and transparency as expressed in Mr. Mirakhor's Preliminary statement. We agree that a Stand-By Arrangement with the Fund would aid Pakistan's ongoing reform. Accordingly, we support the proposed decision.

Mr. Rustomjee submitted the following statement:

The recent sharp decline in external reserves which fell to dangerously low levels in the face of relatively large financing requirements has underscored the need for urgent action by the Pakistani authorities to achieve early macroeconomic stability. Although Pakistan's economic growth in 1999/2000 picked up to about 5 percent and inflation slowed to the single digit range, strains in the external sector began to emerge quite rapidly against the background of serious adverse exogenous shocks which has influenced the economic outturn recently. The terms of trade weakened significantly, reflecting the sharp increase in oil prices and this was accompanied by a substantial deterioration in the capital account, characterized by, among others, the decline in external financing, including the withdrawal of assistance from international financial institutions. Coupled with the apparent weakening of macroeconomic policies, the external position came under severe pressure, highlighting the vulnerability of the Pakistani economy.

These developments have brought into sharper focus the underlying structural weaknesses in the economy despite the reform efforts of the past decade. We endorse the strategy of the new government which has expressed the desire to re-establish consistency in the implementation of sound macroeconomic policies. Already, the authorities have demonstrated commitment to make a clear break from the past.

Thus far, bold action has been taken to stabilize Pakistan's external position while undertaking wide ranging structural reforms to promote sustainable and high rates of economic growth in the medium term. We believe the steadfast pursuit of the policies enunciated under the program will be critical if the ultimate objective of reducing widespread poverty is to be achieved.

We commend the authorities for the substantial upfront depreciation of the rupee in recent months which will be crucial for the early establishment of stability in the external sector. However, in the light of the fragility of the external reserve position and the underlying structural weaknesses, it will be important for the authorities to exercise caution as emphasized by Mr. Shaalan and Mr. Himani in allowing an increasing role for market forces. The authorities will need to be mindful of the risk of a free fall of the exchange rate which could have further adverse consequences for the economy.

We note that monetary conditions have been appropriately tightened and we agree with the staff in cautioning the authorities that any prospective easing of interest rates should be made when it becomes clear that the accumulation of reserves provides adequate margins. This implies vigilance on the part of the monetary authorities to closely monitor developments so that appropriate adjustments are promptly made whenever deemed necessary.

In the fiscal sector, we would ideally have expected that a program that emphasizes fiscal consolidation through the strengthening of tax revenue and containing expenditure within prescribed limits stands a better chance of success. Instead, the staff has expressed doubts based on slippages experienced in the past and weaknesses in the tax administration. Here again, we would like to urge the government to remain vigilant and to take additional steps if necessary in order to protect the integrity of the fiscal program. To this end, we would appreciate staff's comments regarding possible contingency measures which could be implemented quickly and also information as to whether these measures were discussed with the authorities.

The reform agenda is quite ambitious and comprehensive in its coverage and calls for determination on the part of the authorities in following through with all the required actions. The authorities are right in working closely with the staffs of the World Bank and the Asian Development Bank in fostering these structural reforms in order to promote efficiency. Some of these measures are significant in strengthening revenue performance or reducing the burden on the budget as in the case of the comprehensive privatization program. We would particularly commend the authorities in their efforts to reduce poverty, including the increase in social expenditures in the current fiscal program to protect the most vulnerable groups. We agree with the staff on the need to formulate a comprehensive social safety net in the context of a medium-term economic adjustment program under the prospective PRGF. In this connection, the authorities deserve to be commended for preparing an Interim PRSP which should provide a basis for articulating specific programs aimed at alleviating poverty in the country.

On the issue of statistical data, we have taken note of the steps that the authorities have made to improve the quality and transparency of public accounts following the incidence of misreporting. Since the improvements are in line with the recommendations of the FAD technical assistance mission, we are confident that the mechanism now in place will allow effective monitoring of developments. Nevertheless, areas of weakness remain especially with national accounts data and the authorities should be encouraged to press ahead with sectoral research studies that would help to establish a more current base year and allow the production of new quarterly GDP series by 2002.

To conclude, we would like to support Pakistan's request for the use of Fund resources under the proposed Stand-By Arrangement. Given the balance of payments need and the strength of the adjustment effort, we believe that the amount of access is appropriate. We also agree that the proposed front loading is in order and should help to reinforce the credibility of the program. Since all prior actions have been implemented as confirmed by Mr. Mirakhor, we can fully endorse the proposed decision. We also agree that this is only a first step and that the current program should be transformed into a medium-term framework under the PRGF.

Mr. Wei submitted the following statement:

I commend the Pakistan authorities for their firm commitment to bold and comprehensive reforms in a drive to address the long-standing structural issues facing the economy. Since taking office about a year ago, we have seen the authorities' making tremendous efforts to restore macroeconomic stability. Prior actions have also been taken. Macroeconomic indicators have generally improved. Due to the strong performance of the agricultural and export sectors, growth has picked up, with both headline and core inflation declining steadily. This is consistent with the picture of a narrowing current account deficit, notwithstanding the deterioration in the terms of trade. Hence, recent macroeconomic developments have laid a good foundation for the government's continuing reform efforts. Since I am in broad agreement with the staff appraisal, I will make just a few brief remarks for emphasis.

Fiscal policy

Past experience suggests that fiscal reform over the medium term is central to the overall reform agenda. The authorities' recent efforts have been encouraging. We understand the outcome of the reform program will critically depend on the authorities' ability to continue their fiscal consolidation. In this regard, I am encouraged by their commitment to cut the budget deficit through strengthening demand management on the one hand and implementing fiscal structural reforms on the other. Both the staff report and Mr. Mirakhor's helpful preliminary statement have already detailed many measures and steps that are being taken or are to be taken. Here, I would particularly like to emphasize the importance of strengthening the revenue sources (but without undermining the need to contain expenditure. Broadening the coverage of the good and services tax, overhauling the current income tax system, and tightening tax administration should top the list of the reform agenda. Thus, I agree with the thrust of the MEFP in this respect.

Monetary policy

Before uncertainties subside and market confidence stabilizes, I agree that the authorities should maintain a relatively firm monetary policy stance. I am also glad to hear that the authorities stand ready to tighten further, should market conditions warrant such an action. This is important, especially since the effects of the recent rupee depreciation and the increased utility prices and tariffs are expected to feed through to consumer prices in the foreseeable future. That said, the effect of all this is likely to be one-off. In this regard, it is encouraging that the authorities' policy stance is in line with the Fund's technical assistance recommendations.

The most pressing task for the authorities is to restore external payments stability. Although the current account deficit has been reduced, the balance of payments position remains vulnerable. I commend the authorities for taking courageous steps to facilitate the smooth transition to a market-driven exchange rate system by making two recent large exchange rate adjustments. However, recent experience appears to argue for a more gradual strategy when reforming the exchange rate system in the future. In these circumstances, we welcome the authorities' various reform measures in the financial and trade sectors which will definitely strengthen the country's ability to deal with external shocks.

Structural reforms

Structural reforms hold key to the success of economic reforms in the long run. Both for the overall efficiency of the economy and in the support of the longer-term fiscal position, I would encourage the authorities to continue with public enterprise reforms. Special thanks go to the World Bank and the Asian Development Bank for their assistance in this area. On trade liberalization, I welcome the pre-announced tariff reduction schedule, which makes the reform process more predictable and commits the authorities to its implementation. On the financial sector, it is encouraging to see continued rationalization of the NSS targeted at reducing financial market segmentation and further narrowing of the subsidy element of the EFS.

Conclusion

Given the authorities' firm commitment under the program and their prior actions, I fully support their request for a Stand-By Arrangement. I also agree with Mr. Mirakhor that a PRGF-supported program would benefit Pakistan by putting its economy more firmly on the reform path and address the country's external financing needs in a fundamental manner. Finally, I wish the authorities every success in their future endeavors.

The staff representative from the Middle Eastern Department [Eken] made the following statement:

I would like to update you with some information that we have received today on exchange rate developments. In the interbank market, both the selling and buying rates were about 28 Pakistani rupees per U.S. dollar, which implied a depreciation of over 12 percent, as had been envisaged. The kerb market rate was below 61 rupees per dollar, again as had been expected after the lifting of the margin requirements on import letters of credit. The spread has come down and is currently below 5 percent.

We have been informed by the authorities that a meeting with the HUBCO Chairman has now been scheduled to discuss the remaining outstanding issues. The meeting is scheduled to take place during the week of December 14-16 in Saudi Arabia. The authorities informed us that the Minister requested World Bank participation in this meeting.

Regarding the financing of the program, we have been informed that agreement has been reached with commercial banks on the rollover of the foreign currency deposits of institutional investors. As for two Citibank syndicated loans, negotiations have been concluded and an agreement is expected to be signed in the first week of December. Another loan from the Islamic Development Bank, in an amount of $80 million, is to be signed in the first week of December. Earlier in the current week, the Asian Development Bank approved one of the project loans, amounting to $55 million, which was included in the program outlined in the staff report.

I would also like to cover the general topic of governance, an issue that was highlighted in a number of preliminary statements, and that came up during our preliminary discussions with a number of Executive Directors' offices. As noted in Mr. Mirakhor's preliminary statement, improving governance is one of the pillars of the authorities' reform agenda. In terms of substance, governance is addressed through various measures in almost all sectors. The presentation in the staff report might not have brought that out as clearly as it should have done. Therefore, I would like to highlight briefly how the governance issues are addressed in various sectors of the economy and in the reform program.

It may also be useful to go back to the guidelines on the IMF's role on governance issues. In that regard, basically two broad areas are envisaged. One is improving the management of public resources; and second, supporting the development of a transparent and stable economic and regulatory environment. Most of the measures that have been, or are to be, implemented aim to enhance governance and transparency in either one of these areas.

With regard to improving the management of public resources, in the fiscal area, the program includes the taxpayer registration drive, which aims to enhance governance by broadening the tax base in a fair and transparent manner. The reduction of General Sales Tax (GST) and customs exemptions also helps in achieving a simpler and more equitable tax structure, with less scope to rent-seeking activities. The elimination of the tax exemption schemes, formation of a special tax committee and tax Ombudsman's office aimed at fairer treatment of taxpayers, and the new income tax will also contribute to achieving a simpler and fairer tax structure.

In addition, the authorities' reform plans in the public enterprise sector aim at improving the management of public resources.

Major steps have been taken to improve data reporting, accounting, and reconciliation procedures—all of these will fall into the governance area. The authorities have participated in the fiscal module of the ROSC, and its recommendations are being implemented. They have also requested participation in the Financial Sector Assessment Program (FSAP).

The development of a transparent and stable economic and regulatory environment includes financial sector reforms, the loan recovery drive, and the elimination of subsidized credit. Governance in the banking sector has been improved through better supervision, and will be aided by steps to enhance commercial orientation of the banks. Also, independent regulatory boards are being established in the power, gas, and petroleum sectors. The authorities are undertaking these reforms in the framework of a consultative process, which involves participation of business leaders, professionals, academicians, and nongovernmental organizations. Other areas include the oil price adjustment mechanism that has currently been put in place and is being implemented, and the changes in the exchange rate and trade regimes, in particular, the elimination of the customs-related Statutory Regulatory Orders (SROs).

In terms of the substance, governance is broadly addressed through various measures in almost all sectors of the economy. However, there might have been a problem of presentation, which staff will try to address in the future.

The staff representative from the Policy Development and Review Department confirmed that the program had substantive elements with respect to policy measures on governance that covered the two main areas approved by the Board, in particular, the improvement in management of public resources, which was to cover the treasury functions of the budget, central bank operations, civil service, and public enterprises, as well as official statistics. In addition, administrative functions and procedures in the budget related to expenditure control, revenue collection, and tax measures, were also a focus of the proposed program. This program would also support the development and maintenance of a transparent and stable economic and regulatory environment, the details of which included the oil price adjustment mechanism, the exchange and trade regimes, and the banking system.

While the authorities highlighted governance issues, as evidenced in the letter of intent, the presentation in the staff report was diffuse, the staff representative continued. One could have made a more effective demonstration of the authorities' effort in the governance area by organizing the paper in a slightly different manner along the themes outlined earlier by the staff representative from the Middle Eastern Department. Moreover, the staff report could have highlighted this issue at an earlier point.

Mr. Mirakhor made the following additional statement:

> After reading a number of my colleagues' statements, I thought that some response perhaps may help to avoid possible repetition of material and possible two-handed interventions by myself during the discussion.
>
> I thank all the authors of the preliminary statements for their support. One of the issues emerging from these statements is the strength of ownership and track record, and the other is to restore credibility and confidence by the government; strengthen the commitment to public enterprise reform, and improve financial viability of state-owned enterprises.
>
> Let me first address the question of track record and the strength of ownership. I can assure the Board that no one is more concerned and more aware of the problem of the track record of Pakistan than the present government; it is a very serious problem for them. In fact, it took the authorities some time to recognize that they have to own that track record, even though they had nothing to do with it.
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> As suggested in one statement, the authorities have set out to restore credibility and confidence expeditiously. They also realized that this is a very difficult task and an uphill battle for them, in the sense that surely everyone recognizes that credibility is something that is easy to lose, but very difficult to restore. Previous governments' overpromises, under-performance, stop and go practices, and lack of delivery, in general, were something that the present government has promised to try to correct. Early evidence of their concern, awareness, and sensitivity to the issue was demonstrated by the fact that as soon as they discovered discrepancies in fiscal data reporting, the authorities immediately reported it to the Fund, and without any hesitation, despite the fact that a number of people, including myself, had pointed out to them that, given the heightened sensitivity of the Board to the issue, retribution would probably be heavy with the earlier cases and that probably Pakistan will have to pay a much heavier price than later cases. Nonetheless, they went forward;

they reported it and went through the process. Subsequently, they have also implemented all the measures in order to pre-empt the recurrence of similar difficulties in recording fiscal data in the future.

This is a military government. It is a government that could have, and can do, a lot by simple edict. But experiences with previous governments—non-elected governments—proved interim governments proved that reforms by fiat are not sustainable. Therefore, they chose the method of trying to get as broad a consensus and participation as possible, acting decisively when necessary. So far, it has taken a long time for the present government to get where they are today because, as the staff was suggesting, they went through a participatory process of including all the stakeholders in and out of government in decision on reforms, not only in terms of the interim PRSP, but also in decisions regarding the health, education and welfare systems, and basically in major sectors of the economy. Nonetheless, when it was necessary, they also acted decisively.

One case in point is when this government felt that, in order to make the fiscal position more sustainable and viable, they needed to reform public enterprises, they took action. I have talked about the Karachi Electric Supply Corporation (KESC) and the Water and Power Development Authority (WAPDA) in my statement. However, there is another example that one can use, and that is Pakistan Railways. Just yesterday, for instance, more than 40,000 workers were laid off there in order to ensure that this particular public enterprise becomes financially viable. This enterprise, which 12 months ago was basically a major drain and source of hemorrhage on public finance, is now financially in balance.

So, the government has used both methods: whenever necessary, it has acted decisively, and whenever possible, in order to make it sustainable, it has gone through extensive consultation in and out of government at the local, provincial, and national levels. For once, this program in terms of ownership was put together by the government itself. I think that the staff can testify to the fact that, unlike previous times, when staff had to go to the government to try to argue logically and have the government buy into the reform programs, this time the government invited the World Bank and the IMF staff to come in and be convinced of the reform program that they were putting in place.

Evidence of ownership is apparent in many parts of the staff paper in terms of what the government has done. It would have been easy, for example, in terms of fiscal adjustment, to get a much larger fiscal adjustment than the 1½ percent of GDP schedule by simply acting by edict and increasing petroleum taxes and prices, as has been done in the past. This government decided deliberately to move in a consultative way to make sure that all stakeholders are involved to broaden the revenue base and the tax base, and, at the same time, to reduce expenditure levels. This painstaking way in which the tax base has been broadened, in which government expenditures are brought in line, has been difficult and slow. At the same time, it will prove to be more sustainable and more durable.

Let me now point to other evidence—which unfortunately has gone somewhat unnoticed—of the country's and government's intention to become transparent and to improve governance, and also evidence of the ownership of the government of this program. That is their decision to publish the Article IV consultation report. This is a major, major move in this country. I am sure Directors would view that this is a fair staff report and a fair assessment. Some colleagues have referred to it as a candid statement, but it is also a very rigorous staff report. A military government who would be concerned about transparency would probably be reluctant to have the staff report published, but the present government wants to be accountable and transparent. The authorities want to signal that there is improvement in governance by publishing the staff report. This is an additional reason why one should think that they not only own this program, but they are also holding themselves to accountability not only in the Board of the IMF, but also before their own people.

Mr. Al-Turki made the following statement:

Pakistan's economic performance over 1999/2000 has been broadly favorable. Growth picked up, inflation decelerated, and the external current account deficit declined sharply. Notably, these achievements were registered in the face of worsening of the terms of trade and a drop in external financing. Assisted by a buoyant agricultural sector, the economy has also benefited from progress in the authorities' reform effort. The main challenge at this stage is to restore investors' confidence by stepping up implementation of the economic and structural reform agenda. In this regard, I endorse Pakistan's request for an Stand-By Arrangement supported program. Full implementation of the agreed policies should help address the immediate concerns and set the stage for a PRGF supported progam which, as Mr. Mirakhor notes, provides a better framework for implementing Pakistan's reform agenda.

Fiscal consolidation is rightly the cornerstone of the authorities' program. Slippage in this area has been the weak link in previous stabilization efforts. Therefore, it is essential that the targeted reduction in the fiscal deficit be fully achieved. On the revenue side, the importance of broadening the tax base and strengthening tax administration cannot be overemphasized. In this regard, the measures taken to enhance enforcement of GST collections are reassuring. However, further efforts are needed to effectively collect the GST from the retail sector and to overhaul the income tax ordinance.

On the expenditure side, I endorse the emphasis on rationalizing current spending. It is also important to postpone low priority development spending. Such policies are needed to tighten the fiscal stance while providing for increased social spending and the investments required to enhance growth prospects. Here, I am reassured by the steps to improve fiscal monitoring and by the contingency measures which could be implemented if needed to achieve the fiscal target.

Fiscal restraint along with tightened monetary policy should facilitate achievement of the authorities' objective of limiting broad money growth to that of nominal GDP. Such a stance should help contain inflationary pressures, strengthen the external capital account, and facilitate the transition to a market-oriented flexible exchange rate regime. In this connection, I welcome the authorities' commitment to limit their interventions in the forward foreign exchange market and encourage them to limit their purchases in the kerb market.

To achieve the full potential of the macroeconomic adjustment efforts, the authorities need to continue to press ahead with structural reform. The ongoing reform of the financial sector is especially important. Here, I welcome the measures taken to rationalize the National Savings Scheme and to improve the financial position of the banking system. In this regard, I am reassured by the acceleration of the process to privatize banks. The authorities' request for participation in an FSAP and the commitment to implement the recommendations are also welcome.

Turning to other reforms, I welcome the progress made in strengthening the performance of public enterprises in the water and power sectors. The resolution of tariff disputes with independent power producers is especially important. I am also encouraged by the planned trade liberalization agenda .

In conclusion, Pakistan has made a start in addressing its difficult economic situation. The authorities' recognition that this will not be easy and that macroeconomic adjustments must be reinforced by a credible structural reform effort are encouraging. The key to success, however, is steadfast and sustained implementation of the agreed policies. A return to stop-and-go policies of the past will be very costly.

With these remarks, I support the proposed decision and wish the authorities success in the very challenging task ahead.

Mr. Milleron made the following statement:

I welcome this opportunity, albeit a long delayed one, to discuss this request for a Stand-By Arrangement by Pakistan. It constitutes a first step toward the full reintegration of Pakistan within the international financial community, and signals the authorities' intention to engage in a comprehensive reform of their economy, underpinned by the resumption of international financing flows. Considering the large number of significant measures already adopted by the authorities over the last several months, and given the very tense balance of payments situation faced by Pakistan, it is unquestionably time we approved Pakistan's request for an arrangement. Thus, I support the proposed decision.

I fully subscribe to Mr. Mirakhor's diagnosis that the main challenge now facing Pakistan is twofold, namely, "to achieve rapid and convincing stabilization (…) and to press ahead with a broad range of structural policy reform." I thank him for the useful complements he just provided. However, he will forgive me if, being a little blunt, I say that I remain with real doubts as to the chances of success of the proposed program, for two reasons: firstly, because I think the program fails to address decisively the most serious problems that plague the Pakistan economy; and, secondly, because the ability of the authorities to keep the program on track is surrounded by many uncertainties. Let me elaborate briefly on these two points.

As far as stabilization is concerned, the program focuses on monetary and exchange rate policy when the crux of the problem is of a fiscal nature. I certainly do not mean to argue against maintaining a prudent monetary policy and refraining from spending rapidly disappearing international reserves in defense of a possibly overvalued exchange rate. But I doubt that it is adequate to talk about a "rapid and convincing stabilization" with a fiscal program which will result in raising the debt-to-GDP ratio to 93 percent from 90 percent, and which brings down the fiscal deficit from 6.5 percent to 5.2 percent when the economy is expected to grow by 4.5 percent.

As to the structural measures envisaged under the program, I concede that they cover a broad range of issues, but through the same piecemeal approach that has characterized efforts to date and never in much depth. I would have expected much more about such pressing and critical issues as reducing the complexity of the tax structure, modernizing the Central Revenue Board, improving the profitability and governance structure of public enterprises and banks, or containing the risks, especially fiscal, of enhanced decentralization. I also note that the structural reform program is rather backloaded, as compared to the schedule of disbursements.

Moving on to the uncertainties surrounding the achievements of the program targets, I will only note that the growth forecast might prove overly optimistic in the absence of the exceptionally favorable climatic conditions which prevailed last year, and if one takes into account the possibility that official GDP data for 1999/2000 might have been inflated by statistical problems, as suggested by Staff. Likewise, the revenue collection target already seems at risk, in view of the disappointing results observed over the first fiscal quarter. Barring enhanced structural reform efforts, this shortfall will imply a cut of current expenditure. In this connection, I note that the contingency expenditure cuts pre-identified by the authorities consist, once again, of development expenditure, instead of unproductive ones. Finally, it is doubtful that the already low FDI flow projections can be met, short of a significant improvement in the investment climate. In that regard, the privatization program somewhat lacks credibility given the lack of precise timetable and the poor condition of most would-be candidates for privatization.

Turning now to the external financing requirements considered under the program, I note that the public sector's net contributions are not matched by private sector flows of the same magnitude, and that the present program envisages a lower level of private sector financing than the preceding one. I can also confirm that the Paris Club has indicated its willingness to negotiate a new rescheduling agreement with Pakistan. During the negotiation, Paris Club creditors will reexamine the relevance of assumptions regarding the treatment of external debt. Nevertheless, it must be underscored that successive debt reschedulings cannot provide a sustainable solution to Pakistan's external financing difficulties.

Finally, in relation to the article IV consultation, I would like to associate myself with the questions raised by Mr. Mozhin and Ms. Vtyurina in their preliminary statement regarding statistical issues. These are very important to us and I commend the authorities for the time and effort they have invested, with the help of Fund Staff, in fixing the most patent statistical deficiencies and improving the transparency of the management of public resources, including central bank reserves. I was somewhat appalled by the presentation of remaining shortcomings provided by staff, but I thank them for the candor of that appraisal and trust it will speed up the resolution of outstanding issues.

Mr. Pickford made the following statement:

I think it is fair to say that, in the past, many members of the Board have been disappointed by Pakistan's programs, which have proved ineffective and have quickly gone off track. Mr. Mirakhor was very candid about the problems facing the current government. As a result, we and others have stressed the importance of prior actions, conditionality, and clearer assurances that the authorities will act on those conditions. I think what we are faced with here is another last chance for Pakistan to move on to a sustainable development path, and I think it needs also to be acknowledged that the Fund's own credibility is at risk in supporting this Stand-By Arrangement. Nevertheless, we are encouraged by the evidence of prior actions and the explicit performance criteria and benchmarks contained in this program. On balance, we are prepared to support the request, albeit with considerable reservations, which I will spell out in a little detail.

To allay our fears and to build broader support for what we hope will be a transition to a PRGF, we will be looking to the authorities to demonstrate their commitment to reform by fully achieving—indeed hopefully overachieving—structural and fiscal reform targets and to meet those preferably ahead of the deadlines. I need hardly add that implementation will require close monitoring and intense dialogue with staff. In that regard, I welcome Mr. Mirakhor's statement that the authorities recognize the need for extreme vigilance and accuracy with regard to reporting and reconciliation of fiscal data. I also welcome the fact that the government has put in place measures to prevent a recurrence. I support the staff proposals with regard to the publicizing of fiscal data misreporting.

Mr. Shaalan and Mr. Milleron subsequently have characterized fiscal policy as the Achilles' heel of the economy, and I might also add, the Achilles' heel of this Stand-By Arrangement. In the staff appraisal, the staff concedes that higher tax revenues are predicated on improvements in tax administration, but this is precisely an area where performance has always been poor. In this context, I wonder how realistic the target is for increasing tax revenues by 1.1 percent of GDP, again as Mr. Milleron points out, given that the first quarter figures have been disappointing.

I would also welcome further comments from the staff on the work of the special committee which has been formed to look at tax administration issues, since this is an important part of the program. I would also stress the absolute necessity of prioritizing and protecting poverty reduction expenditures, an unfortunate event that future expenditure cutbacks are required to meet the fiscal deficit targets. In that regard, given the risks to the fiscal outlook, I think this is another reason for the authorities to be particularly cautious on any moves to reduce interest rates.

Also in the staff appraisal, the staff notes the vulnerability to terms of trade shocks and concerns that the program may not trigger sufficient investor confidence and private capital inflows to meet Pakistan's substantial external financing needs. Given the potential balance of payments impact of a delay in a return of foreign flows, I think this point deserves more emphasis among the downside risks. I would also add that it is crucial for investor confidence and sentiment to bring to a satisfactory conclusion, as early as possible, the longstanding HUBCO dispute.

With regard to the external financing gap in 2000-01, this is to be covered in part by a rollover of $825 million of foreign currency deposits falling due. The news on the Citibank loan is obviously welcome. While we also welcome this element of private sector involvement (PSI), I would be interested to know how the Fund determined that this was the appropriate level of PSI relative to other creditors, to echo the point that Mr. Milleron made, and also how this fits in with the reduction in IPP tariffs, which staff notes is a further PSI contribution. The external financing side also represents a risk, and it would be good to have some comment on possible contingency plans, if the authorities are unable to secure the further rollovers required.

I would like now to turn to governance and transparency. I am grateful for the staff's presentation at the start of the meeting on the emphasis that the government has placed on this issue. I would take issue with Mr. Mirakhor's preliminary statement, where he comments that these are important adjuncts to the overall policy reform agenda. I was going to say that I regard transparency and an accountable government as absolutely vital elements; I think Mr. Mirakhor has basically covered that point in his oral intervention.

I think there is a positive side here. Both the work on the ROSC and the authorities' request to participate in the FSAP in 2001, together with publication of the ROSC module, MEFP and the Article IV report, are all positive steps. Also, the commitment to use the output from the FSAP to guide future structural reforms in the banking area, which I believe should be required as a feature of any longer-term program, are also important. On the subject of banking reform, again, could I ask the staff to comment on the implications of transformation to an Islamic financial system? I am not quite clear how that affects overall developments in the banking system.

My last main point is on the PRSP, which I regard as essential in the longer term for developing a comprehensive strategy for the country. I welcome the government's work to date on the interim PRSP. I believe it still requires much stronger links to the budgetary process. Notwithstanding the efforts that have been made so far and Mr. Mirakhor's comments on that, I still think that wider participation from civil society is necessary in terms of completing the full PRSP. Also, I think it is important to ensure consistency between IMF support on the one hand, and World Bank and Asian Development Bank programs on the other. We will be looking for an integrated approach that puts the Poverty Reduction Strategy at the center of all of these programs.

In conclusion, let me reiterate that we are prepared to support this Stand-By Arrangement, but, in so doing, we would look to the authorities to rapidly make up the implementation deficit, which I believe has bedeviled programs here for so long. I hope this is the last "last chance" that will be required.

After adjourning at 1:05 p.m., the meeting reconvened at 2.46 p.m.

Mr. Kelkar made the following statement:

Let me begin by thanking the staff for a set of comprehensive papers for today's discussion. The staff and the authorities deserve to be commended for their fruitful dialogue over an extended period of time and agreeing to a comprehensive policy package. As noted by Mr. Mirakhor in his helpful preliminary statement, the staff has also provided high quality of technical assistance to the authorities in various fields.

The overall economic condition in Pakistan has been difficult since the last Article IV consultation though growth and inflation performance remained satisfactory during this period. The country has remained vulnerable to external shocks due to a very weak external position with the official reserves declining to dangerously low levels. The proposed Stand-By Arrangement, which our chair supports, provides an opportunity to the Pakistani authorities to make a clean break from the past and establish a good track record of performance by implementing the reform agenda as agreed with the Fund. As pointed out by the staff, the Fund-supported programs have gone off track on a number of occasions in the past. Therefore, the authorities need to vigorously monitor the implementation of the proposed program to improve macroeconomic stability and address the deep-rooted structural problems facing the Pakistani economy. In my remarks, I would like to highlight two such major policy areas, namely, (i) fiscal stance, and (ii) operation of foreign exchange market.

The staff report has underscored the need for fiscal adjustment as one of the key requirements for the success of the program. I fully agree that the authorities should forcefully pursue the program of fiscal consolidation to address the serious and long-standing problems in this area. If we look at the Table 5 on Consolidated Federal and Provincial Budgetary Operations, we notice that current expenditure has exceeded total revenue in each of the year from 1993-94 to 1999-2000 and the gap is showing an upward trend. In this regard, the continuous decline in development expenditure from 5.2 percent of GDP in 1995-96 to 2.6 percent of GDP in 1999-2000 remains an area of concern, considering the sizeable social needs and infrastructure expenditure demands in the country. The program for 2000-2001 has envisaged a reduction in fiscal deficit by 1.3 percentage points of GDP which is predicated on an improved tax revenue collection amounting to 13.8 percent of GDP, as compared to 12.7 percent achieved in the year 1999-2000. This implies a growth rate of about 20 percent in tax revenue which can turn out to be ambitious, considering the weak performance in the first four months of the current year. Similarly, the program envisages a reduction in interest expense by 1 percentage point of GDP, which also appears to be difficult to achieve in view of the recent tightening of the monetary policy stance and a further possible depreciation of the currency under the current more flexible exchange rate regime. Given these uncertainties in achieving the fiscal target, the authorities are encouraged to continue with their efforts to strengthen the revenue base, extend the GST to agricultural inputs and large retailers, and improve the tax administration. I welcome the planned fiscal structural measures in the implementation of GST, customs and income tax system, and taxation of agricultural incomes. The authorities are encouraged to implement identified contingency measures, if needed, which depend more on cut in non-development expenditure than cut in the development expenditure to meet the deficit target.

As noted in the staff report, the external position has remained very difficult in the country. The external debt to GDP ratio, the external debt service, and the ratio of the present value of public and public-guaranteed external debt to exports are very adverse. Similarly, Table 3 on Indicators of External and Financial Vulnerability shows that the coverage of gross official foreign exchange reserves to short-term external debt is only around 34 percent. This underscores the need for taking urgent measures to strengthen the functioning of the foreign exchange market, in particular, enhancing the depth of the interbank foreign exchange market. The staff report has extensively covered the functioning of the kerb market which, in our view, has proved to be a major source of vulnerability for the smooth functioning of the foreign exchange market. As indicated in Box 3 of the report, there are reportedly around 400 unlicensed moneychangers functioning in the kerb market and some inflows in this market may be related to illegal exports. On the demand side, a large share of foreign exchange purchases from this market are reportedly linked to payments for smuggled imports of consumer goods and to capital flight. The staff report also mentions that some of the demand for the foreign exchange in the kerb market also stems from those who wish to avoid taxes. In such a situation, does not the decision of the State Bank of Pakistan to make large purchases from this market raise questions about the propriety of such transactions? My authorities are seriously concerned about this matter and strongly feel that this practice should be discontinued at an early date. Like Mr. Yoshimura and Ms. Saito, our chair notes that the authorities have agreed for a gradual reduction in kerb market purchases over the medium term, but we feel that the commitment of the authorities need to be translated into a concrete timeframe. In paragraph 21 of the report, the staff has mentioned that the existence of parallel foreign exchange markets also gives rise to the possibility of a multiple currency practice as all current transactions are required to take place in the interbank market and only cash transactions should take place in the kerb market. However, some current transactions do in fact go through the kerb market. The staff has indicated that they will continue to monitor the situation closely for possible multiple currency practices under Article VIII, Section 3 of the Articles. We expect that the Board will be briefed about this matter as well as the progress made by the State Bank of Pakistan regarding discontinuation of purchases in the kerb market at the time of next review of the program.

We welcome the strengthening of the Central Directorate of National Savings which is a step in the right direction for improving the controls and financial reporting in the non-banking sector and therefore the quality and reliability of fiscal data. However, this covers only the problem on the financing side of the fiscal deficit. In an earlier report on misreporting, the staff had given an assessment that the expenditure data in Pakistan are generally deemed to be less reliable than revenue and financing data and the authorities' interpretation of conflicting information on expenditure data is usually guided by financing and revenue data. Therefore, there is an urgent need for strengthening the control and financial reporting system including those Ministries and Government Agencies reporting major deviations in the period 1993-94 to 1998-99.

We are encouraged by the proposed structural reform in the trade sector with a medium-term liberalization program centered on a pre-announced reduction in the maximum tariff rate and in the number of tariff slabs. We agree with the staff that the authorities should continue with their efforts to make the trade system more open.

The proposed Stand-By Arrangement provides an opportunity to the authorities to achieve the goal of macroeconomic stabilization. We, therefore, support the proposed decision and wish the authorities success in their future policy endeavors.

Mr. Le Fort made the following statement:

General issues

We join other Directors in commending the staff on the very good work done in preparing these papers. This has been a lengthy process, but the delay is well justified if this dialogue allows to overcome the problems that in the past frustrated the attempts for macroeconomic stabilization. Recent macroeconomic performance has been satisfactory, however, some fiscal weaknesses remain. The shortfalls in public revenue have resulted in a higher public sector deficit that has disrupted monetary policy and contributed to pressures on the exchange rate and the external accounts.

We welcome the prior actions described in Mr. Mirakhor's comprehensive preliminary statement. Pakistan is ready to advance in an invigorated reform plan directed at improving credibility, rebuilding a solid external position, and promoting sustainable growth and poverty reduction. The challenges ahead are particularly significant, and we concur that they encompass both macroeconomic stabilization, and the implementation of structural reforms that would allow for the resumption of sustainable growth. Under those conditions a longer program span seems to be justified and we would like to call for staff's comments on the reasons for having this program supported by a Stand-By Arrangement instead of some form of extended facility.

Exchange Rate Regime and Monetary Policy

In view of the fiscal conditions, unfavorable external shocks and an accommodating monetary policy, the rupee has been under pressure. Policy intervention has allowed to contain the depreciation of the currency and inflation remains reduced, but current conditions imply significant risks for macroeconomic stability.

We welcome the efforts made by the authorities to adopt a market-determined exchange rate. The low level of reserves and the large gross external financing requirements imply that there is little room for exchange market intervention. In particular, we share the concerns expressed in Mr. Mozhin and Ms. Vtyurina's preliminary statement on the risks for the external financial position implied by forex market intervention through forward or swap transactions.

A successful floating exchange rate regime requires a supporting monetary policy targeted at achieving price stability. To this end, a first condition is to have an independent monetary policy and avoid fiscal dominance in policy setting. In addition to a tighter policy stance, institution building for monetary independence appears to be a requisite for succeeding in making price stability the permanent objective of monetary policy. The staff report indicates tightening policy by targeting growth in reserve money. We would like staff comments on this point, in particular regarding the predictability of the demand for money in Pakistan and to what extent stable paths of market interest and exchange rates could be expected to result from this setting. What alternative guide for monetary policy would be used to replace the reserve money target, if money demand volatility prevails?

Fiscal Policy

We concur with Mr. Junguito and Mr. Dhanpaul that Pakistan should make a very serious effort in adjusting fiscal policy, particularly through revenue enhancing. We welcome the efforts carried out at improving tax administration procedures and taxpayer registration, and at widening the tax base by extending the sales tax coverage to include services and retail operations and eliminating exemptions to customs duties and income taxes.

We share staff's concerns about the difficulties in reducing budgetary expenditures in the short run. But restoring confidence may require some medium- and long-run commitments. In this regard, it is of particular interest to impose strict discipline and appropriate incentives for spending at the provincial level. In general, expenditures are more decentralized than tax revenues, but the ratio of own-source revenue to expenditures of provinces and local governments is particularly low for Pakistan, with the gap usually filled with governmental transfers. This could lead to several problems, including a reduced accountability, since the decision to spend may be taken not facing the cost of providing adequate financing, and the inherent risk for macroeconomic stability, which often is considered the responsibility of the federal government only.

We agree with Mr. Yoshimura and Ms. Saito that stabilizing the economy and restoring market confidence is the first priority. However, a comprehensive strategy encompassing structural measures, some of them already in the implementation phase, is needed to successfully confront the challenges of reducing poverty and attain sustained growth. We understand that this is an initial step that opens the way for a comprehensive and ambitious reform agenda. Consequently, we support the proposed arrangement and encourage the authorities to persevere in their effort and wish them success.

Mr. Bernes made the following statement:

I appreciate the decision by management to recommend that the Pakistan authorities undertake to establish a track record of good performance under an Stand-By Arrangement before a proposal for a concessional Fund arrangement is brought forward for Board consideration. The program's emphasis on structural measures is also appropriate given that in Pakistan, even when the political will exists to undertake much-needed reform, history has shown that entrenched interests particularly within the civil service have presented serious obstacles to meaningful action.

The approach management has recommended has certainly made it easier for this chair to support the proposed program, something that it was not able to do previously. The program staff have described, and the prior actions taken by the authorities can hopefully serve as the start to a renewed and constructive relationship between the Fund and Pakistan. Whether or not this is the case will depend primarily on the authorities themselves and their ability to implement the actions to which they have committed themselves.

That being said, I have a few general comments on the program and I will focus the remainder of my remarks on my expectations for the program, particularly as they pertain to any follow-on Fund arrangement.

On the program itself, it goes without saying that the timeliness and accuracy of data are of paramount importance given the weakness of the fiscal and national accounts and Pakistan's history of misreporting to the Fund. That Fund management is prepared to recommend to this Board that we proceed with the first disbursement under the program despite the conclusion of the Stage One safeguards assessment that safeguards "may not be adequate" to manage Fund disbursements should not be viewed casually by the authorities. Such a recommendation is truly an act of faith on the part of management—and if we approve this program (as I think we should)—on the part of this Board as well. Obviously—and as staff indicate—it would not be appropriate for a recommendation to complete the first review under this program to be brought forward without the authorities having addressed any critical vulnerabilities identified in the Second Stage safeguards assessment.

The data issue, however, is part of a broader concern with the quality of governance in Pakistan—at both the national and provincial levels—and how it is addressed in the program generally. It is here that I had been most uncomfortable and I therefore very much appreciate the comments that staff made at the start of today's discussion. Indeed, I would hope that the thrust of the comments made by the staff, in particular, should figure prominently in the Concluding Remarks of the UFR part of this discussion. I would also appreciate it if the staff could distribute their statement to the Board subsequent to this meeting.

Having followed developments in Pakistan for some time, it is clear to me that the root of a good many of the country's macroeconomic problems derive from its notoriously poor governance. Too frequently, the lack of public-sector transparency and accountability has led to expenditure overruns, shortfalls in tax collection, poor reserve management, inadequate bank supervision, and last but not least, the misreporting of data to the Fund.

Therefore, as staff noted at the start of today's discussion, if Pakistan is to address its macroeconomic problems, the pursuit of good governance must be at the core of any reform program. Governance should therefore have been more fully and explicitly integrated into the staff report, particularly given the authorities intention to publish it, and I would like to commend staff for having proactively acknowledged this point. That the authorities give a higher profile to these issues in their letter of intent is also welcome, and if published alongside the staff report, will provide welcome perspective to the program's conceptual underpinnings. I should note, in passing, that good examples of how governance issues have been reflected in staff reports can be found in some of the work being done in the African Department or European II where a more coherent and integrated approach has frequently been taken in a number of country programs and surveillance reports.

Turning to other aspects of the program, I very much appreciated staff's frankness in pointing out that, in the near term, the poor are likely to be adversely affected by the projected increases in domestic prices of major food items, increases in the cost of household energy, and other program measures. The discussion in paragraph 34 suggests that the planned expansion in social and poverty-related spending is not expected to fully cushion the impact on the poor and that a more fundamental reform of the social safety net is a medium-term objective. That being said, I would have hoped that the program would have gone beyond only protecting the quantitative targets for social and poverty-related spending and made specific provisions to allow increases in spending in these areas should revenue come in stronger than expected or should expenditure savings be realized elsewhere in the budget. In this regard, I wonder if staff or the World Bank representative could comment on the authorities' capacity to absorb additional resources into social-sector spending targeted to the poorest segments of society. I would also appreciate it if the World Bank representative could comment more generally on what progress has been made on civil service reform.

I will say little else on the details of the proposed Stand-By Arrangement since staff have covered most of the other bases well. Let me turn, instead, to where I hope this program will lead, and what I believe should be required for the Fund to proceed with a program that draws upon this institution's scarce concessional resources.

Not surprisingly, I would argue that a prerequisite for a follow-on program should be a clear improvement in the quality of governance throughout the public sector. Some elements of this are scattered throughout the Stand-By Arrangement. Staff and the authorities should bring these together and augment them as appropriate. It should go without saying that any follow-on program should have at its core, an explicit, coherent, and comprehensive governance-enhancing agenda, targeted to improve transparency and accountability in those areas that have the greatest impact on, for example, expenditure management, revenue collection, public-enterprise reform, the financial sector and the supporting judicial system.

Finally, I note that movement in the relative magnitudes of spending on the military and the social sectors has recently been in the right direction and the fiscal projection includes an important increase in social and poverty-related spending. However, even after this, the relative magnitudes of military versus social spending remains thoroughly inappropriate—particularly for a country seeking access to scarce concessional resources. This suggests that any new program must be particularly ambitious in seeking to reallocate resources toward the social sectors and away from unproductive purposes, particularly military spending. Admittedly, progress in aggressively bringing down military spending will require that others in the region are also prepared—perhaps in support of their own poverty-reduction efforts—to bring down their own unproductively high levels of military spending. While Pakistan has a particular responsibility in this regard, staff may want to also consider how best to approach this issue from a regional perspective.

Mr. Callaghan made the following statement:

Pakistan clearly needs a stabilization program to stem pressure on the exchange rate and to restore confidence in the economy. Given the urgent need to stabilize the economy, we think it is appropriate to be considering a Stand-By Arrangement at this stage. It gives the authorities the opportunity to demonstrate that they are serious about reform. If such a program is successful, it could be a precursor to a PRGF-supported program.

The need for a stabilization program stems from the failure of a series of adjustment and reform programs that have been attempted over the past decade, and a lot has already been said about this. But we are faced with a difficult conjuncture of events. We have the pressing need for a program to stabilize the economy, supported by Fund resources, and we have the knowledge of the country's track record over the past decade of implementing the required policy responses. We know that this record is disappointing.

The policy requirements are spelled out in the staff paper. Mr. Mirakhor has already noted that it is a fair report with a degree of candor in the comments. I think the papers are forthcoming around the likely success of the program. We share all the concerns that have been expressed by the staff and by previous speakers. There is clearly little, if any, room for slippage with this program, and these concerns are enhanced because of Pakistan's track record with Fund-supported programs. As Mr. Shaalan and Mr. Himani pointed out in their statement, any policy slippage at this time, even if minor, could well have a significant impact.

The current government announced when it came into office in October 1999, that it was going to implement a bold and comprehensive program to tackle many of Pakistan's economic problems. Bold and firm steps toward reform of the economy are exactly what is needed. In Mr. Mirakhor's oral comments about his authorities' recognition of the legacy they face with Pakistan's poor track record with past Fund-supported programs, and the resolve to implement this program, are extremely welcome. I think it is fair to say that while there has been some prior action, it is still on the basis of the commitments by the government, rather than what has been achieved to date, that we support the program.

On that basis, one of the issues the Fund faces is whether there is sufficient measures in this program or whether they can be established for the program, which may, in fact, help the authorities in terms of successfully implementing the program and restoring confidence.

One possibility is to back-load the resources under the program. I know the staff have pointed out that a moderate front-loaded phasing of purchases is designed to take account of the very low level of reserves and the need to boost market confidence. However, we are balancing concerns over significant risks to the maintenance of the program against the urgent need to stabilize Pakistan's external position. We also know that the failure of the program—even minor slippage, as Mr. Shaalan notes—could be particularly destabilizing to confidence. Against these competing concerns, we think there is an issue about whether there is something that could be done, perhaps through back-loading resources, which may even assist with the chances of its completion, and if anything, it may be a signal that this program is different from the past ones, and that the authorities are determined to maintain progress in implementing it.

Turning to the program, it is well laid out in the staff report. Staff note that, given the uncertainty involved, some cushion has been built into it. In the circumstances, the issue is whether there is sufficient cushion. The cushions apparently refer to conservative assumptions in the parameters in the budget for contingency measures on reducing outlays, if revenues fall short of program targets. Unfortunately, even at this stage, the prospect of having to utilize such contingency measures is probably real. The concept of such contingency measures is sound, although I note in Mr. Shaalan/Mr. Himani's comments that the level of expenditures to GDP is already very low. This underlines the urgent need to bolster the revenue base of the government's accounts, not by increasing rates, but by bringing more taxpayers into the net and improving administration. Pakistan needs to boost its revenue performance if it is to meet the substantial expenditure demands it faces, including, in particular, poverty alleviation and improving infrastructure and social measures, while, at the same time, maintaining a fiscal position consistent with debt sustainability.

The staff's Selected Issues paper on tax reform and revenue performance notes that while revenue to GDP has not changed over the last 20 years, there has been significant improvement in nontrade taxes. This is commendable, but the aim must clearly be to lift revenue to GDP. Little comfort should be taken from the observation that Pakistan's tax system is an average performer across country comparison given the country's overall level of development. Such comparator countries also have to lift their revenue performance and, unfortunately, Pakistan is a below average performer on cross-country comparison overall.

Concern must also be expressed about the health of the financial sector. Even the authorities are concerned about the reliability of bank audits. Also, the capital adequacy is likely to be overstated. An FSAP assessment should be given the highest priority.

We very much welcome the comments on the question of governance. I would fully endorse everything that Mr. Bernes said about governance. We would put utmost emphasis on the importance of tangible achievements on this front in terms of improving the basic foundation of the country's administrative structure and improving investor perceptions toward Pakistan.

On monetary policy, given the precarious position of the economy and uncertainty surrounding money demand projections, at this stage it is premature, if not misleading, to hold out scope of a cut in interest rates this year. The authorities have said that they are committed to enhancing the role of market forces in determining the exchange rate, and have also said that they would not engage in outright forward transactions involving the rupee once the program is approved, and that swap operations would be curtailed. I wonder what curtailing swap operations means in practice? Mr. Mozhin has made a number of interesting observations on this front in his statement, which I think are worth commenting on.

The risks have clearly been highlighted by others and by the staff. Yet, we recognize the urgency of stabilizing the economy and concluding a program. Given the risks involved, as I said before, we think that there is merit in giving some consideration to the timing or nature of access to resources, to try and demonstrate that this program is different and the authorities are totally committed to its successful completion.

Mr. Zurbrugg made the following statement:

Like many other Directors and staff, I think Pakistan's relationship with the Fund over the past three years has been characterized basically by unfulfilled promises. Several attempts have been made to initiate the long overdue structural reforms, which would clearly help to better utilize the enormous potential of this economy. Unfortunately, program implementation has been extremely weak, and reform efforts have been seriously hampered by the lack of sufficiently broad-based ownership. Of course, the misreporting that took place over several years did little to improve Pakistan's standing.

I cannot hide the fact that the requested Stand-By Arrangement poses serious problems for our chair. We have been critical in the past regarding Pakistan's performance under Fund-supported programs, and we would have clearly preferred to be discussing today a staff-monitored program (SMP), which could have paved the way for a program under the PRGF. This would have allowed us to establish an adequate track record and assess the authorities' commitment to effective policy implementation. This is basically another way of putting what Mr. Callaghan said by back-loading access.

Although the new government has taken action in some important areas, for us, it is too early to determine if the break with the past has effectively taken place. Mr. Mirakhor's comments in the morning were put eloquently, and I will try to transmit them to my authorities in my report.

I think the staff report clearly shows that the time for taking a gradual approach to an SMP has run out. The external pressures are such that the Fund must play a role in catalyzing external financing if we want to avoid a financial crisis. Therefore, my authorities are ready at this time to support the proposed Stand-By Arrangement, but not without some serious concerns. I would like to highlight some concerns, many of which have already been mentioned by other Directors.

The first one refers to the uncertainty regarding the coverage of large external financing needs in 2000 and 2001. I took note of the staff's initial comments, which bode well in terms of covering the most uncertain part of the financing, which is the rollover of obligations to private and bilateral creditors. I am, of course, assuming that program implementation will be such that projected financing from international financial institutions (IFIs) will be forthcoming. We have no doubt in that, otherwise we would not be accepting this program. What worries me further down the road is that staff clearly shows Pakistan's significant needs for exceptional financing will remain in the following years. Therefore, while we may have bridged the next year, we are still faced with debt dynamics that puts an enormous burden on Pakistan.

As some other Directors noted, I share the view that the assessment of the medium-term debt sustainability is optimistic. It assumes continued growth recovery, fiscal discipline, a decline in both interest rates and oil prices, and substantial growth in exports. Even with strict adherence to the proposed reform program, these factors are subject to large uncertainty, particularly with respect to the speed with which investor confidence can be reestablished. On these efforts, that is, to restore investor confidence, I note that the long running dispute with HUBCO continues to remain unsettled. The government's recent failure to settle this issue has dented investor confidence even more. I welcome the comments by the staff regarding the next meeting on this issue, but if the past is any signal for the future, we might have to wait to see the results. Given the important signal effect for future foreign direct investment flows, it is crucial for the authorities to rapidly bring this problem to a closure. In this context, I must admit that I did not quite understand the usefulness of prior action No. 11 which, I thought at the beginning, was indicating that an agreement should be reached as a prior action, but only by reading it again, I notice that it only concerns the procedures with which the settlement should go ahead. So, I would appreciate some comments for understanding what this prior action actually entails.

The next point is the implementation of fiscal policy. Several Directors have pointed out that this has been a major problem in past programs. I think there is no secret to that. Fiscal consolidation under the current Stand-By Arrangement rightly focuses on significantly increasing revenues. These revenues are desperately needed, particularly to increase social spending. While some fiscal measures have already been taken, the success of revenue mobilization will depend mainly on implementing a broad range of planned measures. In this sense, I agree with Mr. Callaghan that we are accepting this program more on the commitments taken by the authorities than on past action. Given the dismal track record in this area, I would have liked to see more prior actions regarding fiscal policy. I welcome the projected increase in social and poverty-related spending. However, given the still unexpected, unacceptably low level of expenditures, I remain very concerned by the high level of defense expenditure. I share Mr. Bernes' concern in this regard, and with all due respect, Mr. Mirakhor, I think this area of military government does not provide much comfort. I look forward, particularly with a view to moving into a PRGF-supported program, to increased transparency of budgetary procedures, and I look forward to a more permanent shift of spending to its productive investments. This will be an important factor in our future decision to move toward a PRGF-supported program.

Another point that worries us is the stage of safeguards assessment that has taken place. Since this is one of the first, or even the first, time we are dealing with these safeguard procedures, I was surprised by the bluntness with which staff states that we do not know if the State Bank of Pakistan has adequate safeguards in place to manage resources. As has been stated, this takes certain courage to move ahead. While we note that this is a preliminary assessment, I also had a question with regard to the nature of this preliminary assessment since I understand that one of the prior actions was to deliver the still missing documentation which would have allowed for a full Stage One assessment. Also, if my understanding is correct, we have now decided to move into a Stage Two assessment, which I very much welcome, and I urge the authorities to fully cooperate with staff to allow an in-depth assessment of existing safeguards. Since this is the first time, I would just like to note the procedures. Can we go ahead with a preliminary Stage One assessment, and in the case of Pakistan, does this mean the events have caught up and that we are basically going to leave it at a preliminary Stage One assessment and move straight into a Stage Two assessment? This is more for the future, so that I understand better how we are going deal with this issue.

Finally, on governance, I was one of the chairs who talked with staff before the meeting, and was worried about the low profile this issue has received in the staff report. Given the very positive attitude of the authorities to publish the staff report, I think we should also try to sell the measures that the authorities have taken in various areas which are spread across the document. However, given the perception that exists concerning governance issues, I think it is very important to bundle these various measures, and show that they are moving in the two areas that were mentioned, and for which the Fund has a mandate. What concerned us a bit more was the other measures that were measured in paragraph 50 concerning devolution, and more generally, accountability. These are at this stage still very vague in my view, and will need some strengthening if we were to move into a PRGF-supported program somewhere down the road.

With these comments, I would like to wish the authorities all the best in these difficult circumstances. I sincerely hope that they can make good use of what Mr. Pickford called a last, last chance.

Mr. Sdralevich made the following statement:

It is evident that Pakistan is a very difficult case. The record of the authorities in implementing the extremely numerous Fund-supported programs is very poor, and here let me remind the Board that Pakistan has had one of the largest number of programs in the whole membership. In addition to long-term problems, such as the slow pace of implementation of structural reform and the widespread poverty, the country is facing an emergency in external financing which threatens to bring about a financial crisis. In this context, we welcome and support the program prepared by the staff in very difficult circumstances as an indispensable piece of assistance for the country, in its two main functions of short-term macro stabilization and of bridge to a PRGF.

First, let me comment on the program in general. We find appropriate the use of an Stand-By Arrangement, given the immediate needs of macrostabilization and financial assistance. In view of the difficult cooperation between the authorities and the Fund in the past, we believe that the Stand-By Arrangement should be completed—i.e., we should have a track record of an year—before a PRGF can be launched. We would have preferred more conditionality front-loading and financing back-loading, but we accept this structure due to the present emergency.

With regard to structural reform, we take note of the efforts shown by the authorities so far in the preparation of the program. The program itself addresses reform in a number of fields, focusing on fiscal administration. We welcome such focus: the need to increase public savings is a central aspect of the Pakistani crisis that must be addressed to help resolve the current macroeconomic imbalances.

However, on a less positive note, it should be noted that not few of these reforms should have been already completed in the previous programs. We have to remark once again that poor structural reform is the most serious problem underlying the crisis of Pakistan. Furthermore, a consistent and determined implementation of structural reforms is necessary to strengthen the credibility of the program and the catalytic role of the Fund, with significant implications for external financing—but I will address that in a moment.

With regard to macroeconomic policy, we take note of the recent depreciation allowed by the authorities. It is essential that the exchange rate move towards greater flexibility. Incidentally, the liberalization of the exchange rate market has been in the past a source of problems between the authorities and the Fund, and, as pointed out by other Chairs, there are still issues of multiple exchange rates and excessive market interventions. In the current circumstances, a more flexible and presumably weaker exchange rate is better compatible both with the trends in the balance of payment and the extremely low level of reserves. Clearly in the immediate monetary policy will have to take up some of burden to keep the exchange rate at acceptable levels. In the longer run, i.e. presumably beyond the length of this program, a decided fiscal tightening based on a widening of the tax base should allow to ease monetary conditions.

External financing seems to be afflicted by numerous and optimistic assumptions underlying the financing plan. Here we associate with the comments just made by Mr. Zurbrugg. Furthermore, the role of the private sector involvement in this crisis is not too substantial. The program envisages a net outflow of private sector resources, in contrast to a net inflow of IFI resources. We join other Chairs in asking the staff to comment on PSI, including on the size of the lower profit remittances from the energy sector. Let me repeat that the credibility of the program will be crucial for any private sector financing.

Let me close with a remark on institutional capacity of Pakistan. The misreporting cases, the ongoing statistical difficulties, the problems of fiscal administration and governance, and, last but not least, the weaknesses arising from the Fund's safeguards assessment make it clear that institutional capacity is very weak. Deficiencies in this field are not going to be solved shortly, and we support the Fund's effort in this area through technical assistance. Above all, we encourage authorities to step up their efforts and avoid falling prey of complacency, should, as we all hope, the current difficult situation improve. In this we are reassured by the words of Mr. Mirakhor on the strong ownership by the authorities.

With these remarks, we wish the authorities continued success.

Mr. Prader made the following statement:

During the last decade, the authorities in Pakistan have not adequately addressed the structural weaknesses of their economy. The several reform attempts were inconsistent, limited, and not followed up. Frequent changes of government and political turbulence accomplished little beyond aggravating Pakistan's economic woes. The predictable result was that the external position remained fragile, public indebtedness increased, the investment climate worsened, and poverty deepened. If this were not enough, the

Pakistani authorities of Pakistan were found to be in breach of Article VIII, Section 5 of the Article of Agreement by furnishing inaccurate information to the Fund.

The staff report clearly lists the downside risks of the proposed Stand-By Arrangement. The program is based on optimistic but precarious assumptions about the medium-term macroeconomic performance, debt sustainability, and the availability of external financing. Fulfilling the medium-term growth projection while simultaneously correcting the existing fiscal and structural imbalances will require that there be no policy slippages whatever. Given Pakistan's track record till now, the necessary nearly perfect implementation of the Fund program will require a nearly miraculous performance from the authorities.

Several Directors have very concisely commented on the proposed program, and I broadly share their views. Mr. Milleron's criticism of the insufficiently ambitious fiscal adjustment and the mismatch between front-loaded financing and back-loaded structural reform is well taken. Mr. Kelkar's questioning of the realism of the program's assumptions about the growth of fiscal revenues is highly pertinent because achieving the objective of broadening the tax base is crucial for program success. I recognize that the present effort to register more taxpayers, in the face of the popular resistance that has intimidated all previous governments, is an important step. But Mr. Pickford has discovered an "implementation deficit" which casts doubt on the likelihood that the fiscal targets will be reached. Another worrisome situation, in need of correction, is the strange happenings in the kerb market described by Mr. Kelkar.

Nonetheless there are clear and obvious advantages in granting Pakistan's request for a Fund program.

To their credit, the authorities of Pakistan know well what steps need to be taken so that Pakistan can negotiate what Mr. Mirakhor eloquently calls "a long and arduous road of economic adjustment and reform." Today's arrangement will be a first step in that direction. As such, it may require a leap of faith and imagination from Executive Directors. This chair supports the program, because we do not wish to deny the authorities a new chance to begin the needed economic reforms. Some countries apparently require more patience than others. A new chance will require the authorities to carefully and scrupulously implement the agreed actions, and to avoid asking the Board for frequent waivers and remedial measures to correct slippages.

We agree with Mr. Shaalan and Mr. Himani that "the success of the program depends in significant part on the restoration of investor confidence." Three issues are especially relevant in this connection: 1) Resolution of the dispute with the IPPs. Can the staff give us any reassurance on this head? 2)

The revival of the privatization program. Here Mr. Mozhin's questions about the disappearance of the relevant IMF conditionality are very much to the point. 3) Misreporting and transparency. To me it seems that progress in installing safeguards in response to such a famous case as Pakistan's has been awfully slow and incomplete. And even though our policy on safeguards allows us to go forward with the release of the first tranche of a program despite the absence of safeguards, one has to wonder if greater vigilance would not have been appropriate in this case, especially since the Stage 1 assessment of the State Bank of Pakistan found shortcomings that affect the security of the Fund's resources. At any rate, like Mr. Bernes, I wish to stress that our position at the first review will depend on the successful completion of the second stage of the safeguarding process.

We do have other specific concerns, having to do with statistical reporting, and to certain expenditure items.

I agree with the staff that Pakistan's inadequate statistical apparatus may seriously impair the effectiveness of the authorities' stabilization policies. I note Mr. Mirakhor's assurances that the authorities are taking serious steps to improve the quality and transparency of their statistical reporting, including the public sector accounts. I urge them to complete this process.

Finally, for a country with so many pressing needs, Pakistan's so-called unproductive expenditures are severely out of proportion to the dire state of the economy, and as Mr. Bernes has pointed out, out of proportion with the size of social expenditures. In addition, given the immunity of these expenditures to public oversight and the irregularity of statistical reporting on them, it is entirely possible that the actual expenditures are larger than records indicate. Until the authorities demonstrate a decisive commitment to contain these expenditures and include them in the budget and establish firm, consolidated, and transparent fiscal management of the budgetary process, we cannot regard the prospects for an original or blend-PRGF arrangement to be promising. As to the prospective PRGF, I hope that Pakistan, which has relied too much on debt rescheduling, as noted by Mr. Yoshimura and Mr. Milleron, will not now become accustomed to debt relief and debt cancellation.

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

Ms. Lissakers made the following statement:

Overall, there are a number of positive aspects to this program. The authorities have not only committed to policy actions, but have undertaken concrete actions in advance of Board consideration. Too often, promised ambitious reforms in previous programs were not implemented or veered quickly off track. If adhered to, this program would, one hopes, set the stage for sustained reform efforts. We also acknowledge staff's and the authorities' somber assessments of the essential fragility of this program. Both the staff report and the MEFP highlight the extent to which both endogenous and exogenous factors must break in Pakistan's favor in order for the program's goals to be realized. It is thus absolutely critical for the Pakistani authorities to adhere strictly to their commitments to the IMF.

The authorities have made markedly more progress in addressing problems repeatedly highlighted by this Board. The exchange rate has been permitted to move somewhat in response to market forces. Steps have been taken to extend income taxation to agricultural income and GST to services. The authorities' participation in a fiscal ROSC and plans to publish the results of this exercise are also welcome, if overdue. Much technical assistance has been used to enhance the monitoring, auditing, and reporting of fiscal data, though further commitment and consistent efforts will be necessary to yield lasting improvement and even begin to approach best practices in fiscal management. In that regard we deeply regret that the Board was not provided with the fiscal ROSC to discuss today. Could staff please explain the delay, as well as when they propose to bring it forward for Board discussion. The National Savings Scheme has been adjusted to reduce its outsized role in the Pakistani financial sector. We are curious as to whether the NSS audit yielded further recommendations and are interested in staff's views on the audit. The authorities' commitment to undertake financial/monetary ROSC and FSAP will contribute significantly to further strengthen their and our understanding of the challenges ahead in the monetary and financial sectors. The authorities' intention to publish today's key documents is also a significant improvement in transparency. Pakistan's public commitments to renewed trade liberalization are also noted.

However, we are concerned about the fragility of this program given Pakistan's dire economic situation. This program relies heavily on a best case scenario without much indication of how adverse developments will be handled. Staff's sensitivity analysis highlights this problem, since the shocks modeled are not particularly large but would have substantial negative impact on the realization of program goals. GDP, export, and import growth projections look optimistic, along with expectation of a simultaneous pick-up in public and private savings. This optimism seems particularly striking when one looks at the program's financing assumptions, which, while plausible, are not assured. Over $2 billion in financing expected from rollovers may well come to pass, but their sheer volume does introduce some risk. Assumptions on Paris Club rescheduling, while plausible, may not play out exactly as envisaged. Likewise, plans for World Bank and Asian Development Bank financing depend on continued strong implementation of further reform measures. Given the "lumpy" nature of some of the assumed external financing, these risks become apparent almost immediately. These considerations raise questions about whether this program requires enough adjustment. If any adverse developments do come to pass, the onus should be on the authorities to undertake further adjustment.

Exchange Rate. Notwithstanding staff's interesting discussion of the greater efficiency of the kerb market for many categories of transactions, the current exchange rate regime is not a free float, but rather somewhat heavily managed, as evidenced by the ongoing, fairly constant kerb market premium, and some recent appreciation of the rate. Indeed, there would appear to be significant scope for arbitrage between the official and kerb rate, under current circumstances, in the absence of a firm constraint on access to foreign exchange at the official rate. Going forward, this premium should narrow further if the exchange rate regime becomes genuinely more flexible. We strongly urge the Pakistanis to move in this direction, since more flexibility will provide a necessary cushion if the program's optimistic scenarios do not come to pass. Even if program implementation is impeccable, external shocks cannot be ruled out, and a fully flexible exchange rate would provide a useful cushion.

Fiscal. The program calls for 1.3 percent/GDP reduction in the fiscal deficit, to be achieved through a decline in interest rates and higher tax collections. We note that the single largest component of the envisaged adjustment, an expected drop in the interest bill equal to approximately 1 percent/GDP, will not come about as a result of policy changes. Instead, it is the passive result of past financing decisions that pushed last year's interest bill higher than normal, combined with the debt service structure of these T-bills which pushes any near-term increase in interest rates six months into the future and beyond the monitoring period of this program. Achievement of this deficit target will also depend critically on improved tax collection, which has been the weak spot in all previous Pakistani programs. While prior actions and commitments in this area are encouraging, it remains to be seen whether the revenue target can be achieved as planned. Although there are legitimate reasons for the shortfall, tax revenues to date this fiscal year have not gotten off to a promising start. And while we acknowledge the effort that went into expanding taxation of small businesses, the authorities have so far been unwilling to tackle the most important aspect of achieving fiscal sustainability – increasing taxation of the country's large taxpayers. We do take some comfort from the advance identification of contingency measures on the expenditure side, particularly the plans to restrain spending below budgeted levels in the first half of the fiscal year ahead of hard evidence that revenue targets are being attained.

Poverty / Spending. With respect to the composition of the budget, we commend the authorities' plans to add to social and development spending and to protect it should expenditure cuts become necessary. We are very interested in seeing the final version of the authorities' already prepared interim PRSP and roadmap for medium-term poverty alleviation. We note that the PRSP is to be prepared by January 2002. Although we understand the administrative burdens involved, we wonder whether it would help the authorities' poverty alleviation strategy to move this process forward more quickly. We are encouraged by staff's attention to poverty issues in the Selected Issues paper and urge that this work be incorporated into any future Fund-supported programs.

Like Mr. Milleron, we are dissatisfied with the small, 0.3 percent/GDP decrease in military spending. We question why deeper cuts in military spending were not programmed to provide scope for stronger fiscal adjustment or for higher social expenditures, and why contingency expenditure measures will come at the expense of development rather than military spending. Attainment of even this unambitious target will need to be watched closely since defense spending overruns were a key component of Pakistan's misreporting. Staff indicates that better monitoring mechanisms are now in place to prevent a recurrence of these actions, and we would like to hear more on precisely how these differ from past practices, how much confidence they have in the new mechanism, and their views on the quality of data being provided.

Safeguards. We welcome the steps taken in this case to implement the new safeguards framework, including Pakistan's publication of an independent external audit of its central bank's financial statements. We also appreciate staff's initial assessment of the authorities' internal control procedures, financial reporting and audit mechanisms based on documents made available. Given the preliminary judgment that adequate systems are not in place to ensure the integrity of central bank operations and appropriate management of resources, including Fund disbursements, we attach very high priority to the on-site review and identification of corrective measures as soon as possible. We would have strongly preferred that this second stage be completed before any decision to disburse, but in any case this more in-depth review must be completed before the first review, with needed improvements identified and a response from the authorities provided – as required for under the new safeguards framework. A strong effort should be undertaken to put in place any corrective measures before further disbursements.

Labor. Pakistan's record on core labor standards continues to be seriously deficient. Rights of association and collective bargaining are seriously restricted, child labor and bonded labor continue to be practiced, and women continue to be discriminated against in employment and education. We note staff's report that the government has signed a memorandum of understanding with the ILO to undertake a National Program for the Elimination of Child Labor. We urge the authorities to implement serious efforts to move children, both male and female, out of the workplace and into school, and make available the resources to make this feasible.

Governance/HUBCO. Paragraph 53 on page 34 notes that IPP cost overruns, construction delays, and the renegotiation of 12 IPP tariffs have resulted in a lower-than-anticipated return on equity, and consequently, lower profit remittances abroad. We find it troubling that these lower-than-anticipated capital outflows are characterized in the staff report as an avenue of financing by the private sector, as it could be misinterpreted as implicit Fund support for such a policy response to BOP pressures. In this context, we reiterate our oft-stated concern that the lack of a credible resolution to the HUBCO dispute is reinforcing the impression that Pakistan is a high-risk place to do business, discouraging much-needed foreign investment. We urge the authorities to move with dispatch to resolve this dispute, particularly now when the two sides are not very far apart in their positions.

As stated above, we see numerous sources of risk in going forward with this program given the fragilities described above. Consequently, it is imperative that the authorities follow through scrupulously on their program commitments throughout the program period and complete all envisaged reviews. This will be essential in order to establish a credible track record of policy implementation ahead of moving to a medium-term adjustment program supported by a PRGF. In that respect, we would appreciate confirmation from staff that the end-June targets, currently shown as indicative, will be converted to performance criteria at the time of the first review.

Sanctions. U.S. domestic law, and specifically the Glenn Amendment through its reference to the International Financial Institutions Act, states that the U.S. Executive Director is to oppose (meaning, inter alia, to abstain from voting or vote against) non-Basic Human Needs IFI assistance to non-nuclear weapons states that detonate a nuclear explosive device. On May 30, 1998, the President of the United States determined that Pakistan detonated a nuclear device, triggering this Glenn Amendment provision. The U.S. Government has stated that it would consider waiving Glenn sanctions against Pakistan, should it sign the Comprehensive Test Ban Treaty. The Government of Pakistan has not taken such actions. Accordingly, we are not in a position to vote in favor of this program.

With that said, the United States also recognizes the critical economic problems faced by Pakistan at this time, and encourage the authorities to address these problems and follow the agreement it has reached with the IMF. However, in light of provisions of U.S. domestic law, the United States will abstain.

Mr. Wei made the following statement:

I will be very brief since my position is quite similar to that of Mr. Shaalan and Mr. Himani. Let me just single out one point on the exchange rate issue since my view may be different from others.

> On one point, I agree with others that there is a need for the authorities to unify the exchange rates as early as possible. However, given the large differential between the official and the kerb rates, as indicated by the staff in the morning, I do not think that it is realistic for the authorities to solve this issue in a very short period of time. Also, given the experience in China, the exchange rate unification was achieved in more than ten years. Of course, China is larger than Pakistan, and the issue was also more serious than the Pakistan case. Nevertheless, I believe during the recent exchange rate adjustment, there were large fluctuations on the exchange rate, which created a lot of problems to the authorities. So, in this circumstance, I suggest a gradual approach might be more appropriate for the Pakistan authorities to consider.
>
> In concluding, given the strong commitment by the authorities to the program, and prior actions they have taken, I strongly support the proposed decisions and wish the authorities success in the implementation of the program and access to the PRGF.

The staff representative from the Middle Eastern Department stated that fiscal policy was at the core of the program; most of the structural reforms that were part of the program were formulated to address the fiscal problem. The success of the program would depend on whether the authorities moved along the envisaged fiscal path in 2000/01 and over the medium term. The program was formulated such that, on the revenue side, the emphasis was on structurally sound measures that would provide sustainable improvements over the medium term, without quick-fix revenue measures.

After the revision to the 1999 fiscal data, the revenue targets for 2000/01 were not as ambitious as before, but were still ambitious, the staff representative remarked. Whether the targets would be achieved depended on the implementation of the planned reforms that were part of this program. The authorities were determined to achieve the revenue targets and had identified contingency revenue measures as well as putting into place some of the contingency measures. Since November, the General Sales Tax (GST) on sugar had been applied based on actual rather than notional prices, which was a new element and not included in the program. This was expected to yield about 2 billion rupees. The authorities had also stepped up tax collection efforts in the previous month, and intensified the follow-up measures against tax non-filers. Another measure that was not in the program, but was currently being considered, was the rationalization of the export rebates. During the past five years, gross customs receipts had declined by about 19 percent, whereas refunds had grown by about 50 percent. So, on a net basis, customs duties had declined even more. The reason was that the amount paid by the Central Board of Revenue (CBR) in terms of GST rebates for exporters was not determined by the actual GST paid by the exporters on their inputs, but by a certain notional amount based on fixed proportions. Nevertheless, the authorities had started to address that issue, with assistance from the Asian Development Bank; additional savings from a rationalization of such GST rebates was expected to be about 5 billion rupees.

On the effect of trade liberalization on revenue collection, the share of trade taxes in total revenue had declined considerably, currently at about 2 percent of GDP, the staff representative said. However, the tariff rates in Pakistan were relatively high at about 24 percent on average, with a weighted average of around 19 percent. The high trade taxes had led to the proliferation of smuggling into the country, which had also affected kerb market transactions. According to staff analysis, there was a negative relationship between exports, as a percent of GDP, and the level of import taxes; a reduction of 1 percentage point in the tax rate could be associated with an increase in exports of 0.3 percentage points, as a percent of GDP. Thus, trade liberalization could have a growth potential, which, in turn, would generate revenues. It must also be emphasized that tariff cuts needed not imply a large loss in revenue, given large exemptions and concessions in the system, such as the export rebate system and Statutory Regulatory Orders (SROs), which, if streamlined or rationalized, could lead to declining tariffs, in parallel with an increase in revenues from trade taxes.

As regards the performance and capacity building of the CBR, the tax administration reform committee had been formed and their recommendations would be presented by year's end, the staff representative said. The technical assistance missions from the Fund's Fiscal Affairs Department had had discussions with the committee on many relevant issues during their last visit. The audit capacity of the CBR was also being improved through the hiring of additional auditors.

On the fiscal expenditure side, where there were concerns regarding expenditure control mechanisms and overruns during the previous program period, the authorities had taken major safeguards in controlling expenditures, particularly military expenditures, the staff representative remarked. These safeguards included line item control within the defense allocations, whereby transfers between the line items required approval of the Ministry of Finance. Moreover, a more realistic defense budget had been programmed; a revised data series based on audited accounts provided the basis for staff projections. Military spending would be reviewed at least once a month, jointly by the Ministry of Finance, the Ministry of Defense, and the Military Accountant General. In addition, the monitoring of fiscal developments from the financing side had been strengthened as part of the improvement in reporting that had taken place during the past year, and procedures for the reconciliation of military data from various sources had been improved. Currently, military expenditures were being monitored by the Ministry of Finance, through the fiscal monitoring committee, as well as through reports of the central bank.

On harmonization of taxation and subsidies, the direct electricity subsidy to consumers had been eliminated, and thus had not been envisaged under the program, the staff representative explained. There was currently a subsidy that was provided by the budget to WAPDA because of the way the GST had been designed at the time it was extended to electricity. In terms of the harmonization of provincial agricultural taxation, the program included, in addition to land-based taxes, agricultural income taxes that were the same for all provinces, and taxation of agricultural wealth in parallel with that for non-agriculture—all of which had not been initially envisaged.

Ms. Lissakers noted that among the positive features of recent tax developments were the structural changes provided in the tax law, which, if implemented, would contribute to a sound and equitable tax structure in a meaningful way.

The staff representative from the Middle Eastern Department, in response to the question on the exchange rate policy, remarked that the authorities had committed to a fully market-determined system, unlike in previous cases where there had been a lack of such commitment and unofficial trading bonds had been put in place. As advised by the Monetary and Exchange Affairs Department's (MAE) technical assistance team, the authorities were moving forward to improve the institutional set-up of the interbank market, and undertaking reforms to improve the efficiency of the interbank market. Starting in the first quarter of 2001, those reforms would be implemented carefully and gradually to avoid any possible disturbances to the market. The planned reform measures, which included the elimination of various restrictions on commercial banks' trading activities in the interbank market, might increase short-term vulnerability of the exchange rate system if undertaken all at once. Staff would monitor exchange rate developments in both the interbank and the kerb markets on a daily basis. Such monitoring would include reports on the timing and the amounts of central bank intervention in the interbank and kerb markets. Subsequently, staff would conduct a follow-up assessment of the implementation of MAE's recommendations.

As regards the nominal anchor of the program, the staff representative explained that the use of reserve money as a nominal anchor—despite the observed instability of money demand—was to allow flexibility on the exchange rate side in the event of external shocks. Given the fragile balance-of-payments position, the focus of Pakistan's program was on the external situation and the international reserves. In terms of policy responses other than the exchange rate to a large external shock, fiscal policy would not be helpful in the short run.

On the auditing of the Central Directorate of National Savings (CDNS), the audit report revealed that regular reconciliation between the National Bank of Pakistan and most of the national savings local centers had not been carried out, and, that the cash ceiling of the National Savings Schemes had often not been observed, the staff representative continued. Moreover, there had not been regular reconciliation between post office outlets and the State Bank of Pakistan. Such practices had increased the chances of misreporting and misappropriation of funds. Following the CDNS audit, the staff had recommended further audits covering a larger sample of sales outlets for the period 1999-2000, as well as follow-up audits on a regular basis to assess progress.

The indicative targets for end-June would be converted to performance criteria for end-June at the time of the first review, the staff representative confirmed. Swap operations had not been included either as a performance criterion or an indicative target; rather, the program had as a performance criterion the net foreign assets of the central bank, adjusted upward for any increase in swaps and forward sales over and above the amount recorded in August 2000

The staff representative from the World Bank remarked that significant progress had been made during the past 16 months on the resolution of tariff disputes between the government and the Independent Power Producers (IPPs). Starting from 12 IPP-related disputes cases in the fall of 1998, 6 cases had been solved in the subsequent 6-8 months. Of the 6 remaining—and highly contentious—cases, 5 had been completely solved in the following 12 months. The only unresolved dispute was related to the Hub Power Corporation (HUBCO); however, both sides had recently reached a stage of mutual satisfaction, with the differences between the two positions being narrowed and a legal agreement being currently drafted. The HUBCO dispute was technically complex—sometimes politically difficult—and had continued through a long and intensive series of negotiations, in which the World Bank had been involved directly as a facilitator at the request of both parties. The nature of the negotiations and assumptions used could have significant financial implications for the two parties involved; a small change in the percentage used might have significant financial implications for many years thereafter. The case had been further complicated by the differences of view within the Board of Directors of the company, which represented different groups of shareholders. Nevertheless, a major milestone had taken place in early September at a meeting in New York, whereby a set of specific proposals had been presented and agreement on most of the proposals was reached. Subsequent discussions took place in Prague, London, Islamabad, and elsewhere. The latest discussion had taken place on November 27, 2000, and the next round of discussions was expected on December 14, 2000, when a final agreement was expected to be reached as both sides had strong political will to resolve the dispute. The World Bank representative would be present at the meeting if requested.

The World Bank's participation had been particularly important at the times when the two parties had seemed less willing to discuss with each other, but, often, when discussions had moved smoothly toward a close, the World Bank had not been invited, the staff representative remarked. A case in point was the September 10 meeting in New York where the World Bank was not present, but received the copies of the papers that reflected changes made by the two parties.

Turning to civil service reform, the World Bank had been helping the authorities closely over the past 12 months, while preparing a possible Structural Adjustment Loan (SAL), the staff representative said. An initial memorandum was expected to be submitted to the Operations Committee of the World Bank during the month of December, and subsequently to the Board in early 2001. While the World Bank's involvement in Pakistan's civil service reform dated back a number of years, earlier attempts had not been that successful—particularly the one in 1997. Only after the government had taken the twin approach to reform in the beginning of 2000 had there been impressive progress on this front. The twin approach would address the cross-cutting issue to restore the integrity and the quality of the civil service, through substantial changes in the Federal Public Service Commission (FPSC). Such changes and the depolitization of the FPSC were important issues that would be included as prior actions in the World Bank's SAL. The Bank expected a number of positions to be taken in that respect during the first few months of 2001.

In other areas of the federal civil service, the staff representative noted that the government was currently focusing on the reform of the railways, the Central Board of Revenue, and the Minister of Financial Planning; civil servants in the three areas totaled about 400,000. As mentioned by Mr. Mirakhor, there had been substantial improvement in Pakistan's railways; similar achievement was expected for the other two institutions during the first months of 2001.

In response to Mr. Shaalan's question regarding an assessment of other reforms and chances of future success, the staff representative specified three areas which received particular attention in the next World Bank's SAL—banking, power, and oil and gas. Throughout 2000, significant progress had been made in the power sector as well as in the oil and gas sector, and the Bank expected a number of measures to be taken as prior actions by March 2001, to allow completion of the SAL. Liberalization in the oil and gas sector, which was one of the most difficult issues faced by the prior government, had progressed significantly. The Bank believed that this sector was one of the major potential sources of growth for Pakistan, and would attract foreign investment if reforms were implemented as planned. The power sector also saw significant improvements, for example, in the financial restructuring of the Water and Power Development Authority (WAPDA).

Behind all of those reforms, there remained a strong need for improved governance, the staff representative related. In the case of the power sector, the ultimate progress would be measured by the delivery of privatization. In that regard, the World Bank had assisted the government and WAPDA in preparing a program of steps that would ultimately lead to the privatization of the power sector, starting from the distribution level. Such process was progressing well. As regards the banking sector, the Bank had also worked closely with the government on the next steps toward the privatization of the banking sector.

In response to Mr. Bernes's question regarding the capacity of Pakistan to absorb additional resources into the social sector spending area, the staff representative remarked that, while recognizing the importance of both the quantity and the quality of expenditures in the social sectors, there had been tremendous problems in practice to improve the quality side—in particular the delivery of public services—which was a federal issue. A lot of positive changes thus far had been more at the provincial level. Changes at the federal level were expected as part of the evolution that had yet to start. Pakistan was currently in the second stage of the social action program, whose main focus was to maintain total expenditure. Therefore, it might not be appropriate to increase the share of resources for the social sectors until the delivery of services by the provincial and local governments had sufficiently improved.

Mr. Yoshimura commented that the Fund might become overly involved in the HUBCO issue—perhaps to the point of being regarded as micro-management. This was an issue that required proper division of labor between the Bank and Fund. Another concern related to the increased military expenditure and the effectiveness of the review of the monitoring process in controlling such expenditure.

Mr. Zurbrugg requested further clarification regarding the prior action on adequate implementation of an orderly process to resolve a commercial dispute.

The staff representative of the Policy Development and Review Department [Kincaid] conjured that the orderly process of implementation to resolve a commercial dispute was among the list of prior actions. However, as the letter of intent and the Memorandum of Economic and Financial Policies would become a public document, the language had been phrased in such a way that it would not give the impression that the staff had interfered, or favored one party over the other, in the negotiating process, or had placed the authorities at an unfair disadvantage vis-à-vis their counterparts. The staff would be guided by the World Bank as well as the information received independently in determining whether the negotiation effort by the authorities had proceeded in good faith.

On the strength of the program as well as implementation and projection risks, the staff was fully cognizant of these risks, and had clearly and fairly laid them out in the staff report. The staff also intended to closely monitor developments in these areas, the staff representative said. There were some deficiencies in the Program which could be addressed through an Extended Arrangement or a Poverty Reduction and Growth Facility (PRGF). At the current stage, it was essential to establish a track record first. Efforts to articulate a comprehensive strategy to be supported by a three-year fund arrangement were truncated because of the anticipated risk of a capital-induced crisis. The staff and management had felt that if a crisis emerged, the situation would be far more difficult to manage, and were concerned about the set back of progress in structural reforms that had been made thus far. Concerns about a currency/financial crisis also explained the program's phasing test [to monitor] it was the [aspects] issue of front-loading and the level of access. Given the low level of international reserves over the past few months, there had been a need for a large amount of resources and a front-loaded program in terms of its phasing. These reasons were stated in the staff report.

On the related issue of private sector involvement (PSI) in the financing of the program, the staff had no clear answer as to what would constitute an appropriate level of PSI, the staff representative acknowledged. Indeed, when discussing PSI policy, the Board had also recognized that determining the proper level of PSI was a matter of judgment. At one point in the discussions, the authorities had aimed for a rollover rate of 50 percent for foreign currency deposits and the staff had some part a higher rollover rate. Nevertheless, it had been decided that a 75 percent rollover rate would strike the right balance, given the prospect that Pakistan could regain spontaneous access to the private international capital markets. In particular, the authorities were strongly of the view that a rollover rate of 100 percent, which would basically freeze foreign currency deposits, might jeopardize loans under negotiation with commercial banks, thus losing some of the financing assumed under the program and failing to accomplish a greater level of PSI.

With regard to paragraph 53 in the staff report concerning the delays in tariff increases for the IPPs, the staff had not endorsed these actions, the staff representative explained. The point had been brought to the staff's attention by the authorities, and had been included in the staff report to inform the Board.

The Acting Chairman remarked that, on the phasing of safeguards assessments, the new procedure had been established by the Board, whereby the first stage would produce a virtual checklist on itemized documentation procedures. From the checklist, the staff would assess the quality of the present standing prior to reforms and changes before provoking Stage Two, which would be more crucial and binding. For Pakistan, a Stage One assessment had been completed at the end of October 2000 with the collaboration of the World Bank, based on the documentation provided by the authorities, which might have involved some risks regarding documentation and procedures pertaining to civil service aspects. The staff had received full cooperation from the State Bank of Pakistan and was currently moving on to a Stage Two (on-site) assessment, which would engage a mission—scheduled to be in the field starting on December 4. Assessment of de facto vulnerabilities and risks was expected to be completed before the first program review, and the results of the Stage Two assessment would be fully available to the Board.

The staff representative of Policy Development and Review Department explained that a list of prior actions in Table 3, p. 107, was to provide the information necessary for the completion of Stage One of the Fund's safeguards assessment. The staff report on page 39, paragraph 65, confirmed that a Stage One assessment had been completed. The mission for the Stage Two assessment planned to leave on December 4.

The Acting Chairman remarked that, on the question of acts of faith, as the program envisaged several risks—clearly laid out in the staff report and expressed orally throughout the discussion—the staff and management had proposed the second-best solution: a short-term, 10-month Stand-By Arrangement, to provide the track record needed by the new government. Throughout the policy dialogue in the past 9-10 months, the staff and management had seen the authorities' commitment, and hoped to subsequently move forward to another formal program. While there were specific risks in the program, the program must be considered as a package, and the Board had commented positively on that package. One had to make a calculated trust-for-trust decision, and management had judged that there was a rational potential for change and a break with the past. As evidence, a number of prior actions had been adequately completed by the authorities—for example, results from the tax reform revenue, the reform of the National Savings Schemes, the announced reduction in tariff rates, and the move to a flexible exchange rate regime. Nevertheless, the uncertainty that remains has been the reason for the program to include many structural benchmarks and quantitative performance criteria in its reviews. In this manner, as the program moves forward, if the Board agrees to it, its established procedure will draw an intensive policy dialogue in the process.

Mr. Thiam made the following statement:

> First of all, I would like to commend the staff for the well-written and concise papers, which highlight the achievement of Pakistan as well as the challenges lying ahead. We support the proposed decision and we very much encourage by steps taken by the authorities to publish the set of papers.
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> As indicated in Mr. Mirakhor's helpful statement, the economy of Pakistan remained fragile and vulnerable to external shocks. To this extent, we welcome the steps taken, sound policy, and the implementation of

measures needed to put the economy on a growth path, reduce further financial imbalances, and improve the living condition of the poorest segment of Pakistan's population.

On the fiscal front, we would urge the authorities to pursue, over the medium term, fiscal consolidation. We strongly encourage them to carry out tax reforms that can bring about measures and lasting improvement of the revenue and allow the reduction of the heavy public debt.

Further, the reduction of low priority outlays should be sought in order to meet the basic need for education and health, and improve the weak social indicators. In this regard, the sounder wage policy as well as moderation in different outlays would be welcome.

On exchange rate policy, we believe that the continued commitment to a fully market-determined exchange rate will serve Pakistan well. However, to enhance further its effectiveness, we concur with the recommendation aimed at reducing purchases of foreign exchange from the kerb market and by avoiding outright transactions of the State Bank of Pakistan.

With regard to structural reforms, significant progress has been achieved, but much remains to be done. In particular, the trade system remained restrictive, and we welcome in this context the liberalization plan announced by the authorities. With regard to the financial system, sustained efforts are needed to reduce nonperforming loans in the Bank's portfolio. Also, the planned reforms of the National Savings and export finance schemes need to be accelerated. We believe that the authorities' intention to participate in the FSAP is a very welcome step.

On program monitoring, although the risk of recurrence of misreporting has lately diminished, Pakistan should press forward with data compilation. In the paper it was noted lack of coordination and procedures of various government agency were the main factors behind the extent of misreporting data to the Fund. It is, therefore, important to develop viable statistical data to allow for a closer program monitoring and to strengthen program ownership by improving further governance and transparency.

Successful implementation of the program should pave the way for the PRGF.

With these comments, we wish the Pakistani authorities success in their adjustment program.

Mr. Törnqvist made the following statement:

All speakers and statements have emphasized the risks associated with the proposed program. And, also the staff report has certainly spelled these risks out very clearly. I would like to agree with these Directors.

There have also been a number of reservations expressed which are certainly, I think, warranted. I would, in particular, like to agree with the statements made by Messrs. Bernes, Zurbrugg, and Prader. In particular, I would like to associate myself with strong emphasis on governance, and their concern about the high level of military expenditure, as well as the need for transparency in this area. This is an important issue also to this chair, and not least when it comes to considering a possible PRGF, this will be very important consideration for us.

The risks and uncertainties have been well described both by the staff and Directors and I don't need to repeat all of these. The risks, together with the track record of Pakistan, certainly give rise to serious concern.

I would like to mention here the prospects for improving tax collection to the extent required. As has already been said, this has been the Achilles' heel of previous programs, and if I understand the staff report correctly, there are already some signs of slowdown in this area, and I hope that this does not indicate that the efforts are already weakening.

The prospects for getting the necessary external financing also look extremely uncertain. It is uncertain whether investor confidence would return as quickly as anticipated in the program, even with the full implementation of it.

On the other hand, there are indications that the Pakistani authorities have a strong commitment to the program than on previous occasions. They have manifested this by taking a number of substantial prior actions. And it is also a good sign that they intend to publish the staff report.

Like Mr. Prader, I noted the statement in Mr. Mirakhor's concise and well-written statement that the authorities realized that this program is only a first step on a long and arduous road of economic adjustment and reform, and I hope this insight will guide them in their difficult tasks. I am willing to give them the benefit of the doubt, and support the proposed decision.

Mr. Suarez made the following statement:

Since my views have been expressed by previous speakers, I will only express my support for the request of the Pakistani authorities and wish them well in their future endeavors.

Mr. von Kleist made the following statement:

Since I generally concur with the staff recommendations and the gist of other speakers' comments, I shall be brief and only touch on two areas which other speakers have already highlighted, namely, tax reform and the currency market.

Successful tax reform is the most basic and sustainable answer to Pakistan's recurring budgetary woes and debt dynamics. Unfortunately, the most recent staff update indicates that tax collection has already fallen short of the program target. Staff has indicated that additional measures are put in place to ensure program compliance.

Also on the staff paper, it is reported that there has been noticeable increase in the number of filed income tax returns. Still, only 0.5 percent of the population is filing tax returns. Even in view of the wealth distribution, there seems to be a small number and one more indication to broaden the tax base and have effective tax collection administration.

The second area I wish to highlight is the so-called kerb market. One could make a case that the kerb market fulfills necessary economic services, even though some of these services seem to be illegal. It is quite another matter, however, to use public funds to prop up this market. I was disturbed to learn from the staff update that the SBP had increased its purchases of foreign exchange from the kerb market instead of curtailing them. It appears that somebody out there is lining his pockets with the help from the SBP. It is most regrettable that the program does not contain a performance criterion that these intentions have to be scaled down quickly and then stopped all together. If we were to talk about a follow-on program for Pakistan next year, provided this one stays on track, such a provision should be incorporated. It would obviously be more efficient to abolish capital controls this give rise to such peril markets and introduce flexibility into the exchange rate system.

As I said before, and as many other speakers have said, I can only support this request with difficulty considering Pakistan's abysmal track record with Fund-supported programs. My support consists entirely of hope, hope that the authorities who are relatively new on the job will this time enact the necessary concrete measures and do what is best for Pakistan and its people. It is utmost important that the prior actions and the performance criteria are strictly adhered to.

With regard to the remaining financing gap in the program year, I share other speakers, especially Mr. Milleron's , Mr. Pickford's, and Mr. Yoshimura's concerns and the need for PSI. I also expect that this program will run its full length on track before any follow-on may be considered, and also before any follow-on we would need more information on how the financing gaps in the following years may be closed.

As Ms. Lissakers, I regret that the ROSC was only distributed today and so we could not really go through it in detail for today's discussion.

Mr. Yakusha made the following statement:

Given the late time and other countries to have discussions today, I will be brief. I support the proposed decision not without some concerns, and I would like to reflect on the one issue like Ms. Lissakers and Mr. von Kleist. We are displeased by the fact that the transparency report has been issued so late, and in the case of Pakistan, it seems to be a very important paper, highlighting substantial achievements in management, but very serious challenges still remain at the level of provincial governments, especially governance issues.

And I would also like to reiterate that my recollection suggests that it is the first instance that ROSC reports are distributed at the Board meeting. I do not think it is acceptable.

Mrs. Hetrakul made the following statement:

While comprehensive discussions and concerns have already been expressed, being the last speaker, I will be brief.

I would like to commend the Pakistan authorities for their firm commitment to restore macroeconomic stability and to press ahead with the structural reforms. We welcome their prior actions and are encouraged by the improved macroeconomic performance as well as significant progress in reform efforts, which should help pave the way for accelerating the pace of further reforms in the future. This is an opportune time for the authorities to show a nonstop and firm commitment. We encourage the Pakistan authorities to persevere and continue with the ongoing reforms, including establishing good governance and transparency.

We concur with the thrust of the program and the staff's appraisal and fully support the proposed decision.

With these remarks, I wish the authorities every success in tackling the challenges ahead.

The staff representative from the Middle Eastern Department remarked that, on the issue of Islamic banking, staff had provided technical assistance to the authorities in terms of operations. The implications of the transition to Islamic banking for the banking system, as well as its impact on the economic situation, depended significantly on how the preparations proceeded. The first technical assistance mission had emphasized the need to put appropriate infrastructure in place before proceeding with a conversion into Islamic banking, and had recommended that this should take place in a gradual manner. The authorities were moving on this track, and the staff would continue to monitor the situation.

Mr. Mirakhor noted that, much theoretical research has already been done, including by the Fund, and neither the workings of the financial system nor the workings of monetary policy would need to be impaired with the introduction of an equity based-rate of return into the system. There is enough basis to show that, in fact, the stability of the financial system may be enhanced by the introduction of an equity-based rate of return instead of a specific fixed rate of return ex ante. As for Pakistan's specific implementation, it will take some time to see how it will be implemented. Experience in various countries where the system has been implemented showed some success and some failure; the latter was because the governments use the banking system to finance their deficits.

The high-quality selected issues paper was an integral part of the staff report, Mr. Mirakhor continued. If the authorities agreed to publish the staff report, they would likely agree to publication of the selected issues paper, particularly the debt sustainability analysis. He would confirm this with his authorities.

As all other questions have been covered by the Acting Chairman and staff, Mr. Mirakhor noted, all views expressed by Directors would be conveyed to the authorities as quickly as possible. He expressed hope that the degree of skepticism about Pakistan would decrease by the next discussion, and that a favorable track record is established, for the Board to consider.

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

> Executive Directors agreed with the thrust of the staff appraisal. They noted that Pakistan's macroeconomic performance over the past year was favorable in several respects. Growth had picked up, aided in large part by favorable crops, inflation had eased, and the external current account deficit had narrowed substantially despite a large terms of trade shock. In addition, several key structural reforms were implemented, including the introduction of the petroleum price adjustment mechanism, the withdrawal of tax immunities, and the launch of intensified loan recovery and tax registration campaigns.
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> Notwithstanding these favorable developments, Directors observed that a deterioration in the capital account of the balance of payments, together with an easing of monetary policy at the time when the exchange rate was held stable, had weakened the external position and caused the rupee to come under pressure. Also, the budgetary position had deteriorated because of expenditure overruns and continued weak tax administration, which had resulted in lower-than-envisaged revenue gains.

The key policy challenges for the period immediately ahead will be to maintain macroeconomic discipline and improve the competitiveness of the economy and public debt dynamics. If policies to achieve these objectives are steadily carried out over time, private sector confidence would likely improve and the economy would move to a higher and durable growth path, which is essential for reducing poverty. Directors, therefore, welcomed the authorities' resolve to break from the past and improve governance and implement far-reaching structural reforms resolutely.

Directors agreed that fiscal consolidation especially an improved revenue effort is essential for restoring macroeconomic stability. They welcomed the reorientation of public spending to poverty-related expenditures and saw this shift in budgetary priorities as key to sustaining public support for the overall reform effort. Directors supported the targeted reduction in the budget deficit through measures to raise tax collection, tighten expenditure control mechanisms, and improve tax administration. However, in view of the uncertainty surrounding the attainment of the growth objectives of the program and the effectiveness of some of the fiscal measures, Directors urged the authorities to maintain a close watch over revenue and expenditure developments, and to respond expeditiously with additional measures as needed, to ensure that the budgetary target is met, while safeguarding social and poverty-related spending.

Directors agreed that fiscal consolidation needs to continue over the medium term to reduce the public debt burden and create room for a much-needed expansion in social spending, aimed at reducing poverty on a lasting basis. They noted that, in the past, weaknesses in revenue performance have undermined efforts to reduce the fiscal deficit. Directors therefore emphasized that structural fiscal reforms to broaden the revenue base and improve its buoyancy, as well as cuts in less productive expenditure, will be essential. In particular, they urged the authorities to implement envisaged timetables for the extension of the General Sales Tax to the retail sector and agricultural inputs, the overhaul of the income tax law with the 2001/02 budget, the further strengthening of tax administration, and the finalization of the civil service reform plan. Directors considered that faster progress in the drive to register large taxpayers and better revenue collection from the agricultural sector will be essential for the overall fiscal effort. They also noted that strengthening the institutional capacity of the Central Board of Revenue would help the authorities in their efforts to enhance revenue collection. In order to maintain fiscal discipline at the provincial level, Directors recommended that, as the proposed fiscal decentralization proceeds, expenditure responsibilities for different levels of government be assigned commensurate with any reallocation of resources. In general, they considered that structural reforms would be essential for bringing about greater transparency in the regulatory environment and providing greater confidence in the efficient management of public resources.

Directors noted the significant depreciation of the rupee in recent months and the authorities' commitment to allow the exchange rate to be determined by market forces. In this regard, they noted the recent tightening of the monetary policy stance and its likely positive effect to stabilize the exchange rate. Directors cautioned against any premature cut in interest rates, particularly in view of the very low level of official reserves. They urged the authorities to press ahead with measures to develop and deepen the inter-bank foreign exchange market. In this connection, several Directors underscored the importance of measures to check the growth of the kerb market, including through a reduction in the State Bank of Pakistan's purchases of foreign exchange from this market. Observing that the existence of two foreign exchange markets in Pakistan gives rise to the possibility of a multiple currency practice, Directors urged the authorities to ensure that all legitimate current account transactions are allowed to go through the inter-bank market.

As regards other structural reforms, Directors welcomed, in particular, the envisaged reforms of the National Savings Scheme and the export finance scheme, and measures to enhance the commercial orientation and financial position of the banking system. They noted the progress that had been made in resolving tariff disputes with independent power producers and urged the expeditious resolution of the remaining dispute with Hub Power Corporation, which has clouded investor sentiment toward Pakistan. Directors welcomed the restructuring of state-owned enterprises, such as the Water and Power Development Authority and the Karachi Electric Supply Corporation, and stressed the importance of improving the management of these enterprises. They welcomed the announcement of the trade liberalization plan, which would help create a more competitive domestic environment. Looking forward, Directors underscored the importance of reforms in the areas of privatization, the energy sector, and governance to energize the private sector and attract foreign direct investment flows, thereby enhancing Pakistan's growth potential.

Directors noted the authorities' efforts to improve the quality, timeliness, and reporting of data—especially with respect to fiscal accounts. With continuing data weaknesses hampering the analysis of economic and financial market developments, they welcomed the authorities' plan to implement the recommendations of the fiscal module of the Report on the Observance of Standards and Codes and the launch of the program to improve national accounts statistics.

Directors regretted that the recently completed revisions to the historical fiscal data gave rise to incorrect data reporting to the Fund on at least two occasions during 1993/94-1996/97. These constituted breaches of Pakistan's obligations under Article VIII, Section 5 of the Articles of Agreement. However, in view of the remedial actions taken by the authorities since early 2000 to improve fiscal data accounting and reporting, including the audit of the operations of the Central Directorate of National Savings, Directors did not consider that any further actions were needed.

Directors welcomed the authorities' decision to publish the staff report.

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

The Acting Chairman made the following summing up of the discussion on the request for a Stand-By Arrangement:

Executive Directors noted that all prior actions have been met, and approved the authorities' request for a Stand-By Arrangement. However, noting Pakistan's mixed track record under previous Fund-supported programs, Directors strongly urged the authorities to do their utmost to implement the current program without slippages. In this respect, they welcomed the authorities' resolve to make a break from past stop-and-go policies. Directors considered that improving transparency and governance was at the heart of the program, and looked forward to tangible progress in all aspects of macroeconomic management. Resolute actions on this front would help restore much needed investor confidence and spur investment.

In view of the uncertain fiscal revenue performance, Directors urged the authorities to stand ready to implement contingency measures to keep budgetary performance in the first half of the fiscal year up to program expectations. They were concerned that the recent revenue data suggested a shortfall although modest in relation to program targets. While this appeared to be related to the extension of the deadline for filing income tax returns and it seemed that the shortfall could be reversed by end-December, Directors urged the authorities to redouble their tax collection efforts and, in view of the disappointing filings under the self-assessment scheme, they felt that further tax amnesties and other tax concessions should be firmly resisted. While Directors welcomed the programmed reorientation of public spending toward poverty reduction, some Directors expressed concern about the continued high level of defense spending and urged the authorities to accelerate the shift of budgetary priorities toward social spending.

Directors emphasized that, in view of Pakistan's extremely vulnerable external position, the maintenance of a flexible, market-determined exchange rate will be critical. To enhance the efficient functioning of the foreign exchange market, they urged the authorities to reduce the State Bank of Pakistan's (SBP) purchases of foreign exchange from the kerb market and to avoid outright forward transactions by the SBP. Directors recommended that the sale of foreign exchange by the SBP in the inter-bank market be strictly limited to smoothing short-term fluctuations related to lumpy transactions. They cautioned that a cut in interest rates should not be undertaken before the monetary and reserve targets under the program have been met with a comfortable margin.

Directors noted the large gross external financing needs of the program, which many felt reflected the heavy debt burden and a major capital account problem. They recommended expeditious implementation of structural reforms to enable timely disbursements of adjustment loans from the Asian Development Bank and the World Bank. While recognizing the elements of the financing strategy to stem private sector outflows, Directors expressed concern that the financing package implied a small withdrawal by the private sector, and therefore underscored the need for forceful implementation of the agreed reforms under the program that would encourage private capital flows, including foreign direct investment. A few Directors expressed concern about the authorities' reliance on continuous reschedulings with official creditors, and emphasized that the authorities should steadfastly pursue sound medium-term policies with a view to fostering export growth and restoring investor confidence. They also urged the authorities to engage in negotiations with all creditors, including private creditors.

More generally, Directors noted the large downside risks to the program, especially those related to fiscal performance, export growth, external financing, and investor confidence. As the materialization of these risks could compromise balance of payments viability and debt sustainability, they urged the authorities to monitor developments and maintain a close dialogue with the staff so that policies can be adjusted in a timely manner.

Directors underscored the importance of maintaining the momentum gained in addressing data-related issues. They stressed that, by the time of the first review of the program, the authorities should have made sufficient progress in addressing vulnerabilities in this area in the context of the second stage of the Fund's safeguards assessments.

Looking ahead, Directors welcomed the authorities' intention to implement a bold and comprehensive reform agenda, which was derived from a broad consultative process, aimed at mobilizing revenue, reducing poverty, restoring investor confidence, and improving governance. Observing that strong structural measures were envisaged during the next ten months, Directors indicated that strict adherence to all elements of the program could lead to consideration later of medium-term financial support from the Fund under the Poverty Reduction and Growth Facility.

The Executive Board took the following decision with one abstention by Ms. Lissakers:

1. The Government of Pakistan has requested a Stand-By Arrangement in an amount equivalent to SDR 465 million for the period November 29, 2000 through September 30, 2001.

2. The Fund approves the Stand-By Arrangement for Pakistan set forth in EBS/00/230, Sup. 1, 11/20/00 and decides that purchases may be made under the arrangement, on the condition that the information provided by Pakistan on the implementation of the measures specified in Table 3 of the Memorandum of Economic and Financial Policies attached to the letter dated November 4, 2000 is accurate.

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

Decision No. 12335-(00/117), adopted
November 29, 2000

3. FORMER YUGOSLAV REPUBLIC OF MACEDONIA—POVERTY REDUCTION AND GROWTH FACILITY—THREE-YEAR ARRANGEMENT; EXTENDED ARRANGEMENT; AND INTERIM POVERTY REDUCTION STRATEGY PAPER AND JOINT STAFF ASSESSMENT

The Executive Directors considered a staff paper on the request by the former Yugoslav Republic of Macedonia for a three-year arrangement under the Poverty Reduction and Growth Facility and its request for an Extended arrangement (EBS/00/231, 11/15/00; Sup. 1, 11/27/00; and Sup. 1, Cor. 1, 11/29/00). They also had before them a joint staff assessment of the interim poverty reduction strategy paper (EBD/00/95, 11/15/00); and an interim poverty reduction strategy paper (EBD/00/96, 11/15/00).

Mr. Wijnholds submitted the following statement:

I very much appreciate this staff report coming to the Board now, after a long gestation period. In this particular case, special thanks is warranted to the team led by Mr. Banerjee and to Management, for their perseverance in designing a well fitting program in a rather changeable economic and political environment.

The staff report is comprehensive and paints a balanced picture that shows substantial progress on many fronts in the Former Yugoslav Republic of Macedonia (FYRM). After the previous ESAF-supported program ran off-track in late 1998 and the turmoil caused by the Kosovo crisis, the authorities have considerably stepped up their reform efforts since the beginning of 2000, with the new Finance Minister playing a central role in this development. Thus, there has been tremendous fiscal over-performance and structural adjustments have accelerated, including the sale or closure of some of the large socially owned loss-makers. In this regard, I am pleased to confirm that the sale of the Feni nickel smelter, which was a prior action, has now finally been effected under the guidance of a reputable financial advisor.

The authorities have shown their commitment to sound transition by putting in place many of the measures and policies that were already part of the previous ESAF-supported program. At the same time, financial stability has been maintained for many years now. While it took longer than expected to arrive at this stage, following the Kosovo crisis, I believe Fund support for the authorities' program is highly appropriate at this stage. While there is some domestic political tension right now, there appears to be broad support among the political spectrum for the policies set out in the program. Fund support would be instrumental in providing guidance and continued discipline for the authorities and it would also be helpful in guarding against the effects of an unforeseen downturn or external shock. Moreover, Fund support is expected to boost investor confidence and help enhance the integration of Macedonia in the region and in Europe. Last, but not least, Fund support would trigger the release of substantial amounts from the World Bank, the EU and other donors.

One might consider Macedonia a borderline case for Poverty Reducation and Growth Facility (PRGF) support, in view of the graduation from the International Development Association (IDA) eligibility in mid 2001. In this regard, it should be noted that the authorities are serious in their efforts to alleviate poverty, as is demonstrated in the Interim Poverty reduction Strategy Paper (I-PRSP). The country suffers from an exceptionally high unemployment rate, which is officially estimated at 32 percent now. Furthermore, poverty is quite substantial in certain strata of society and pro-poor growth-oriented policies would seem most desirable. Fund support in the form of a PRGF could also be considered as a continuation of the previous ESAF, which was interrupted for reasons partially beyond the control of the authorities. Surely, it is hoped that the proposed PRGF will help Macedonia in graduating from PRGF eligibility by the end of the three-year disbursement period. At the same time, structural adjustment remains the core of the program over the medium and long term. In this light, I consider the proposed mix of 30:70 of PRGF resources and General Account resources as entirely reasonable. In any event, average annual access would be quite modest at 17 percent of quota.

I believe the case for Fund support for Macedonia's program is well substantiated in the staff report. Let me just elaborate on a few of the highlights.

First of all, the outstanding fiscal performance is particularly noteworthy. It can be concluded that the introduction of the VAT on April 1, 2000 has been highly successful, in spite of a relatively short preparation period. I believe the resident tax expert made available by the Fund has done an excellent job and I would like to thank him and the Fund on behalf of the authorities. In a similar vein, important progress is being made towards a centralized treasury system and the integration of off-budget accounts into the budget, also with the help of a Fund-provided expert. With respect to fiscal performance, it might also be pointed out that the authorities have taken a very cautious approach. They have to a large extent been able to withstand pressures to boost expenditures. The main slippage has been the failure to lay off 6,000 civil servants (6.5 percent), which was blocked by the Constitutional Court.

The government attaches high value to a reduction of income taxes in order to reduce the stunning wedge of 75 percent between gross and net wages, which is a key impediment to employment. The authorities have agreed, however, to a cautious approach in this area as well. The required reversal of the present fiscal surplus will only be implemented in the course of next year, subject to a staff and Board reassessment of the appropriate fiscal stance during the mid-year review in 2001.

Monetary policy has served the country well and has led to a sustained period of financial stability, in spite of the external shocks.

The structural part of the adjustment, which is by nature the most difficult to carry out, has really gathered momentum this year. This has been a result of the reform orientation of the authorities. In the area of the banking system, the biggest public bank was sold to foreign investors, the banking law was modernized and international supervisory standards are in the process of being implemented and enforced. Lending practices by commercial banks have already improved significantly since the start of this year. Furthermore, new laws have been introduced in the areas of financial securities, collateral and bankruptcy, which should also help improving financial discipline. With respect to the pension system, the healthcare system and the public administration, reforms have now seriously started with the help of the Bank, in spite of some setbacks that were experienced in this field. For example, the number of government ministries has been recently reduced from 22 to 14. Finally, the financial and symbolic importance of the sale of Feni to a French investor cannot easily be overestimated. This was a crucial step in testing the resolve of the government to solve the problem of the loss-making enterprises. It means that ten out of a list of twelve large loss-making enterprises have now been closed or sold. The main one left is Jugochrom, the sale or closure of which is a benchmark under the program.

With respect to growth, the Kosovo crisis has after all proven to be an unexpected boon for the economy, but this effect may trail off as the regional environment normalizes. The export-led growth prospects for the near future remain favorable, however, based on cautious assumptions. The projected financing gap (after Fund and Bank financing) of $ 30million this year and next year, and $25 million in 2002, appears to be manageable with the indications received so far from donors. It is evident that there are risks to the program, mainly in the area of a failure to stick to the programmed structural reforms. Nevertheless, I believe these risks are mitigated by the reform-mindedness of the authorities and the track record they have established so far, with even some over-performance. The Fund arrangement is a balanced one and it will have a strong catalytic impact, in spite of the modest size of the amounts involved. It should provide a crucial contribution to structural reform of the Macedonian economy, making it more resilient and alleviating the problems of unemployment and poverty.

Extending his remarks, Mr. Wijnholds said that the authorities had decided to publish the report in the staff paper, in addition to the Letter of Intent and the Memorandum of Economic and Financial Policies. Also, the European Union had signed an initial succession and stabilization agreement with Macedonia.

Mrs. Hetrakul and Ms. Manivat submitted the following statement:

The staff report captures the essential elements of the program for the Former Yugoslav Republic of Macedonia (FYRM) and its progress on macroeconomic stabilization, structural reform, and poverty reduction. The case for Fund support is well argued by both staff and Mr. Wijnholds, and we would like to express our support for the use of Fund resources under the PRGF and Extended Fund Facility (EFF) so that FYRM can benefit from the Fund's catalytic role, paving the way for sustainable economic growth in the medium term.

The authorities are to be commended for establishing an impressive track record, implementing many key measures as specified in the previous ESAF-supperted program. The strong fiscal performance in 2000 is a welcomed development which would provide room for maneuvering expenditure more effectively. Improving expenditure management and control, as well as the targeting of social spending, would be integral to the economy. We are also pleased to note that the authorities will adopt a cautious approach in implementing the new fiscal measures in 2001; second-stage measures would be carried out only after the first review of the program.

As pointed out by Mr. Wijnholds, the structural part of the adjustment is always the most difficult. On the banking sector, we note the progress achieved thus far in improving financial discipline and strengthening the legal framework and supervisory standards. It is imperative that the authorities remain committed to financial sector reform, laying the foundation for a sound and dynamic financial system in the period ahead. Meanwhile, enterprise restructuring, if successfully implemented, will create a more favorable environment for foreign investment, and we are encouraged by continued positive developments on this initiative. The effort to overhaul the civil service sector will also be essential to sustain the reform momentum, although this would entail some social costs when the economy is already fragile, with the persistently high unemployment rate and a significant part of the population still living below the poverty line. Mindful of the comprehensiveness of the social safety net and reform strategy, we would like to stress that a careful balance must be struck for an efficient, yet flexible, reform process to ensure that the most vulnerable groups do not falter and that high-quality growth can be achieved.

According to staff's projections, the growth prospects for FYRM are generally favorable in the medium term, with some risks associated with the political uncertainties in the region. Given a favorable external environment, the authorities would still have an ambitious task at hand in adhering to the program and following through with these bold initiatives. In all, we deem the program worthy of international support and wish the authorities every success.

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

Economic performance has been generally favorable during the last year with a pick up in economic activity and a large surplus in the fiscal accounts. Furthermore, financial stability has been maintained in recent years despite the very difficult situation in the region. The main weaknesses, in our view, are in the banking and enterprise sectors.

On fiscal policy, we note the large surplus due to the extremely buoyant VAT collections. Given the current large tax wedge we think it is appropriate to reduce this wedge in order to improve the employment situation. The authorities expect the implied fiscal stimulus to be offset by a recovery in the private sector savings rate. We would like the staff to elaborate on the rationale for this assumption. Given the large current account deficit, we appreciate that the authorities have made part of the fiscal stimulus contingent on such an increase in the private savings rate. We also support the authorities' strong emphasis on strengthening expenditure management and control. In our view, it is very important to improve fiscal transparency and governance.

At this stage, we find the orientation of monetary policy toward an exchange anchor to be appropriate. Given the considerable excess liquidity in the banking system, the central bank faces important challenges in the implementation of monetary policy. In this connection we would like the staff to explain the rationale for the prepayment of government debt to the banking sector and the households. Is the objective to reduce interest expenditure, or is there some other reason? As mentioned in the staff report, the prepayment creates uncertainty and the excess liquidity will have to be sterilized.

The situation in the banking and enterprise sectors gives rise to serious concerns. The loss making state-owned and privatized enterprises incurred aggregate losses of about 4 per cent of GDP during 1997-99. Most of these losses were financed through arrears to workers, suppliers, the government, and banks. Despite the fact that the share of nonperformance of loans in the portfolio of the banks at end-June 2000 was about 40 percent, banks have undertaken few meaningful loan collection efforts, and they have not shied away from doing business with high-risk borrowers. This points to a need to improve bankruptcy and collateral legislation and to improve the management of the banks. We note, however, that in 2000, unlike in 1999, according to data provided by the National Bank of Macedonia, expansion in private sector credit has been directed toward creditworthy borrowers. In any case, the banks will have a heavy burden from the loans extended during earlier years. We would like the staff to elaborate on the reasons for this improvement in the direction of the banks' lending activities.

We note that all 22 banks meet or exceed the required capital adequacy ratio. Given the situation of the banks' customers, meeting the minimum 8 percent requirement may not be sufficient to ensure a stable banking system. Moreover, given the large proportion of non-performing loans and the poor CAMEL rating of some of the banks one might question the accuracy of the capital ratios. Further, staff's comments on the prospects for the banking sector would be welcome.

The situation in the enterprise sector calls for decisive action. We strongly support the actions outlined in the government's memorandum in this regard.

Finally, we support the proposed decision for an Extended Arrangement and an arrangement under the Poverty Reduction and Growth Facility. As mentioned by Mr. Wijnholds in his preliminary statement, one might consider Macedonia a borderline case for PRGF support. Given the events in the region in recent years, and the limited amount of PRGF resources involved, even when taking into account the amounts drawn under the previous ESAF arrangement, we find the proposed decision to be appropriate.

Mr. Schlitzer made the following statement:

We fully concur with the staff and Mr. Wijnholds that the FYRM authorities have proven a renewed commitment to reform by implementing a series of measures that were on the agenda of the previous ESAF-supported program. We find it appropriate that the Fund supports their further stabilization and reform efforts at this time. We are grateful to staff and Management for the work done to this aim.

The program looks strong and well focused and its approval should trigger the release of additional resources from other multilateral sources, including the World Bank. Beyond this, we expect Fund support to exert a strong catalytic effect that should help fill up FYRM's residual financing gap. In this context, boosting foreign reserves is an objective worth pursuing; it will enhance confidence in the exchange rate regime.

As macroeconomic stability has been maintained for some years now and does not seem particularly at risk, the program agenda is rightly focused on structural reforms. In this respect, the choice of a three-year EFF is fully appropriate. However, the authorities are also requesting a PRGF. This is perhaps unusual, but not unprecedented. The case deserves some consideration.

First, FYRM has a per capita income that is double the IDA threshold. While it is correct to argue, as done by the staff, that PRGF eligibility is not formally linked to the criteria for IDA eligibility, we nonetheless think that (a low) per capita income is an important element to take into consideration (albeit not the only one). In fact, the granting of a PRGF to FYRM can only be justified in terms of special circumstances: the previous ESAF-supported program would probably have not expired had the Kosovo crisis not erupted. Moreover, the amount that would be committed under the PRGF is much less than the undrawn balance under the original ESAF-supported program (SDR 10.34 million against SDR 27.3 million). Against this background, one would expect FYRM to graduate from PRGF by the end of the three-year horizon. More generally, it should be clear that we are not setting new criteria for PRGF eligibility, which will continue to be selectively determined by the Board on a case-by-case basis.

Second, it is worth stressing that the granting of an EFF as well as a PRGF in support of the program must entail full "cross-conditionality" between the two arrangements (even if there are separate performance criteria). This seems indeed to be the case. In fact, on the one hand, purchases under the PRGF are conditioned upon fulfillment of the quarterly performance criteria under the EFF (see Table 10 of the main report). On the other, as the semi-annual reviews of the EFF and PRGF will be done jointly, their completion will require satisfactory performance under both arrangements.

With these caveats in mind, we can go along with the staff proposal to grant the Former Yugoslav Republic of Macedonia also a PRGF. This should help maintain the appropriate focus on poverty, which, albeit not being an overwhelming problem, is one that deserves to be addressed.

I will concentrate the rest of my remarks on some aspects of the structural agenda.

In the fiscal domain, we welcome the prudent stance taken by the authorities. It is wise to wait and see how much of the VAT-related increase in revenues is permanent before implementing wholly the planned tax cuts. Yet, the reduction in the very high taxation of labor income, in a situation where unemployment reaches 32 percent, is inescapable. The wage bill continues to be the Achilles' heel of this administration, and after the Constitutional Court's ruling against early retirement of civil servants, the number of available options has shrunk. Containing the granting of further wage increases in the near future would not suffice, and ways have to be found to reduce public sector employment.

In the financial sector, we note the measures taken by the authorities to strengthen banking supervision. The non-performing loan problem affecting several banks has clear implications not only for financial stability but for capital accumulation as well, due to the rigidity it introduces in interest rates, which are far too high in real terms. Monitoring the problematic banks will be crucial and in this regard we welcome the remedial measures proposed by the NBM that constitute a benchmark under the program.

Progress is being made in the area of loss-making enterprises, and we are glad that the sale of Feni, a prior action, could be confirmed. I read that the Government plans to "sell or close Jogochrom (the second largest loss-maker) and four enterprises by the time of the first review" (see Attachment I, paragraph 30). Clearly, sale and closure are not equivalent options from the point of view of the social impact, notwithstanding FYRM's good social safety net. Staff comments would be welcome on this issue.

In the field of statistics, there is scope for improvement in a variety of areas, including poverty. In particular, do the authorities have any intentions to aim for subscription of the GDDS in the near future, as Directors recommended at the last Article IV consultation?

Mr. Weisman made the following statement:

Strong macroeconomic performance is something on which we have come to depend when examining Macedonia. What has been lacking over the years has been a firm commitment to structural reform. As such, we are encouraged by the recent progress on implementing structural measures, which were left unfinished under the previous ESAF-supported program, and hope this represents a serious and permanent change in attitude as we move into a new Fund program. In general, we think the proposed program is a strong one, and we are in broad agreement with the staff report.

Before turning to specific elements of the program, we would like to comment on the proposed financing, where we share some of the concerns of Mr. Schlitzer. While Macedonia's access to concessional financing may have been justified at the beginning of its transition, staff and management have not put forward a convincing argument to explain why Macedonia should continue to have medium-term access to PRGF financing given its GDP per capita and impending graduation from IDA eligibility. While changes in IDA eligibility do not have "an automatic effect" on a country's PRGF eligibility, there is a strong presumption that PRGF eligibility should reflect IDA eligibility unless there are powerful reasons to treat them differently. We are interested to hear staff's reasoning in this case and would note that there are important issues of comparability of treatment.

We believe this case underlines the usefulness of having greater clarity regarding PRGF eligibility, and we look forward to reviewing the list of PRGF-eligible countries early next year. At the same time, we would ask PDR and management why 6 years will have elapsed since the last review of the PRGF-eligible country list and would hope that such reviews will be brought before us much more frequently. It behooves an organization like the Fund, whose basic objectives include promoting sound policies and growth, to show a greater commitment to the principle of graduation. While ultimately we can go along with the financing arrangement, we would state that should this program go significantly off track, we would expect that rather than hold on to the remnants of the old program indefinitely, a new program be negotiated that would not involve PRGF resources.

Returning to the components of the program, we agree with the decision to delay part of next year's tax cut pending the results of the first program review. The proposed tax cuts highlight the importance of decreasing expenditures through a downsizing of the civil service. In this regard, the introduction of interim safeguards for controlling personnel expenditures until a Treasury system is fully developed is also a prudent measure. Nonetheless, we are concerned that the program does not include a more detailed plan explaining how actual downsizing will take place, especially in light of the Constitutional Court's decision rendering the early-retirement law unconstitutional. In any event, to establish credibility it will be very important that the authorities adhere to the agreed-upon ceiling for the central government wage bill.

Integrating the core off-budget special revenue accounts into the 2001 budget and divesting non-core activities to the private sector are crucial to the success of the fiscal strategy. Not only will these actions help prevent further breaches of wage discipline, they will enhance fiscal transparency and good governance. Given the magnitude of this problem, we would ask staff to comment on the progress made thus far.

Acceleration of enterprise sector reform is another crucial element of the program. Given the poor results from privatizations involving insider buyouts, we support the intention of the authorities to move towards more transparent public auctions of enterprises. While we appreciate the commitment to privatize the 40 largest remaining loss-makers by June 2002, we propose that staff and the authorities provide us with a more detailed timetable for achieving this goal.

Strengthening the banking system is also a necessary condition for successful transition to a market economy. The new bankruptcy law and other legislation protecting creditor rights will enhance financial intermediation and reduce the large spread between lending and borrowing rates. On a related issue, we would ask staff to comment on the likelihood of additional foreign participation or consolidation within the banking sector.

The Stage One safeguards assessment of the National Bank indicates that the external audit mechanism is missing. We join staff in urging the authorities to expeditiously address this shortcoming by keeping to the timetable outlined in the staff report.

On statistics, we join Mr. Schlitzer in asking staff to comment on the prospects of Macedonia subscribing to the General Data Dissemination System (GDDS).

We welcome the increased prominence the government is giving to poverty reduction. A comprehensive PRSP will be a useful device, and we fully expect the government to carry out its commitment to follow a broad-based participatory process in its development.

Given the link between poverty and unemployment, we are curious about the continuous downward trend in registered employment, which likely indicates the growing prevalence of the informal sector. The fact that 75 percent of the unemployed have been seeking employment for more than four years is also very disturbing. Comprehensive labor market reform should be an integral part of any poverty alleviation strategy.

We urge the authorities to provide greater clarity in the final PRSP in selecting priorities that will have the largest impacts on growth and poverty reduction. We agree with the four broad focus areas identified by the Bank and Fund, and we would expect particular attention to be accorded both to encouraging small-scale private enterprise and to addressing the constraints impeding rural and regional development. We welcome the commitment to introduce a new legal framework for combating money laundering, but we note that there is scant attention in the Interim-PRSP to other anti-corruption measures. We would stress the importance of including a section on corporate governance in the final PRSP.

Mr. Siegenthaler made the following statement:

Macedonia has made considerable progress in its economic transformation in recent years. The authorities have succeeded in stabilizing prices and strong growth has restarted after a temporary setback due to the Kosovo crisis in the first half of 1999. The strong fiscal performance, which is mostly due to high revenues, not only reflects this strong growth but is also a result of the successful implementation of measures for reforming the tax system. We also welcome the governments conservative stand regarding the use of the larger than expected fiscal surplus in view of the high current account deficit.

Nevertheless, a number of important challenges remain. Clearly, the sustainability of the encouraging growth hinges on further reforms. Macedonia runs a high trade and current account deficit and structural unemployment is a major problem. At the same time, enterprise restructuring and the downsizing of the civil service are indispensable. Continued slippage on the wage bill has been a major problem. Therefore, we welcome the authorities' objective to reduce wage cost and the corresponding inclusion of respective quarterly ceilings as benchmarks under the program. Similarly, we welcome the planned integration of the special revenue accounts into the central government budget in order to strengthen wage discipline and to improve fiscal transparency. We also agree with staff that continued improvements in corporate governance and a stronger banking system are of high importance. Hence, we welcome the progress that has been made in strengthening the legal framework of bank supervision and in enhancing monitoring ability.

Given the good track record and the strong and well-focused program outline, we support Macedonia's request for Fund assistance. I may add that I welcome the intent of the authorities to publish the staff report (announced by Mr. Wijnholds). However, like Mr. Schlitzer and Mr. Weisman, we regret that PRGF resources are intended to be used under the program. PRGF eligibility is based principally on a country's per capita income and eligibility under the IDA. Macedonia does not belong in this category, and there is no obvious reason why we should depart from our principle rule in this particular case. Among the current PRGF arrangements, Macedonia would have by far the highest income per capita and it would be the first PRGF arrangement for a country that is not IDA-eligible. In 1999, Macedonia's GDP per capita has reached US$1,690 compared to US$840 at the time of the approval of the previous ESAF-supported program. The current GDP per capita is thus almost double the IDA-eligibility limit of currently US$885 and corresponds roughly to the median GNP per capita of the countries covered in the World Bank's "World Development Indicators". As a consequence, the World Bank will remove Macedonia from the IDA list in July 2001. We are well aware that PRGF eligibility is not formally linked to IDA eligibility and that changes in the IDA list do not have an automatic effect on a country's PRGF eligibility. Nevertheless, we believe that a country should be allowed to graduate from support under the concessional Fund facility and thus be taken off the PRGF list in circumstances like the ones in Macedonia. There seems to be a certain asymmetry between IDA eligibility on the one hand, which expires when a country has reached a certain GDP per-capita level, and PRGF eligibility on the other hand, which does not seem to expire in the very same circumstances. This Chair would welcome it if the Fund would adopt a similar practice like the Bank, with regard to graduating from concessional assistance.

Like Mr. Schlitzer, we are concerned about the danger of setting a precedent by granting PRGF resources for Macedonia. This facility was set up to help the Fund's poorest members and it should therefore be concentrated on those countries, particularly given the obviously limited nature of these resources. This is even more so in view of our numerous discussions on the Fund's facilities in which, I believe, the Board expressed its will to better focus the Fund's instruments. We therefore insist that by no means are we creating a new interpretation of PRGF eligibility. Rather, the granting of concessional resources in the case of Macedonia must be seen in the light of the special circumstances described in Mr. Schlitzer's preliminary statement.

With these caveats in mind, but in view of the strength of the proposed program as well as Macedonia's good track record, we support the proposed decision.

Mr. Schlitzer pointed out that he had not regretted the staff proposal in support of a PRGF program for Macedonia, which could be justified because of special circumstances. Rather, such a use of PRGF resources should not be interpreted as establishing a general rule.

Mr. Schollmeier made the following statement:

Macedonia has achieved major progress in the reform agenda and established an impressive performance despite sometimes difficult circumstances. Financial stability has been maintained, growth rates and growth prospects are remarkable, inflation is under control, the fiscal position has shifted to surplus and reserves have improved.

Adjustment measures rightly focused on the fiscal sector and structural issues. The introduction of the VAT is an important and commendable step in the right direction. However, major challenges are still ahead: expenditure controls need to be strengthened, off-budget accounts need to be included above the line, and fiscal transparency needs to be improved.

Despite welcome changes in the banking sector, strong and decisive measures are still necessary. It is worrisome to find that few efforts have been made to improve loan selection, primarily because of an insufficient legal framework. Even after several loans were written off, the share of nonperforming loans was nearly 40 percent at the end of June. As usual, it will be no easy task to overcome the heavy burden of nonperforming loans. Some banks still need strong adjustments to improve their performance to become sound. Hence, efficiency and credibility of banking supervision will be essential.

Also structural problems in the enterprise sectors are matters of concern. Though the most recent preparatory actions are signs of progress with regard to loss-making enterprises: five large enterprises are to be privatized in a transparent manner which would satisfy the relevant benchmark for the first program review.

In general, we can go along with staff's analysis. However, we are concerned about one major point. Like most previous speaker's we do not see an urgent need to utilize scarce PRGF resources rather than general resources. Per capita income in Macedonia exceeds the IDA eligibility by a large margin. Even while there is no formal link with PRGF eligibility, it appears that we are going to set a precedent while it should be clear that we are not setting new criteria. We would have much preferred a single program financed by general resources. Also, a pure EFF arrangement would give a stronger signal to managers to build more confidence. Why should we use scarce PRGF resources for borderline cases that are not easy to justify? In our view it would be appropriate to reserve the resources for the poorest countries that qualify for such heavily subsidized support from the Fund.

Mr. Collins made the following statement:

I am grateful to staff for a comprehensive and readable set of papers, and I can support the request for the program. Macedonia has made much progress over the past year, which is a good achievement in itself, given the events in 1999. It is important that this momentum is maintained and that it moves forward in 2001 within the context of an IMF-supported program.

I agree that growth prospects for 2001 and beyond look favorable, but it is important to make growth sustainable by maintaining vigilant economic policies. The key to long-term growth lies on the supply side of the economy.

There have been some notable achievements over the past year, including the introduction of VAT, new banking laws, a new bankruptcy law, and progress with the closure or privatization of loss making state-owned entities, but a great deal remains to be done.

First, on the labor market, unemployment is alleged to be over 30 percent, mainly because of structural factors. Unemployment data will certainly have implications on enterprise restructuring, yet the data is notoriously unreliable. Macedonia has an excessive burden of labor taxes that reduce incentive for job creation, and which may give incentives that result in distortions of the actual employment rate.

Second, there are large number of unviable state and socially owned enterprises. The objectives of the enterprise sector reform program are bold. The authorities need to be willing to take difficult decisions to close unviable enterprises for the long-term good of the economy. It is essential that the laws on bankruptcy and creditor rights are properly implemented and enforced.

Third, the banking sector is still threatened with insolvency, and I would encourage the authorities to press ahead with banking sector reform. I welcome the progress that Macedonia has made in strengthening the legal framework for bank supervision, and in enhancing monitoring capacity.

Fourth, Macedonia's nonproductive civil service should be streamlined.

On the broader macroeconomic front, it is clear that Macedonia has established and maintained financial stability over the past several years. There has been good inflation performance and a welcome improvement in the country's reserve position, despite erratic inflation after the introduction of VAT. I am concerned about the robustness of the assumption that private savings will rise in 2001 to offset the implied fiscal stimulus from the budget. Changes to the fiscal stance need to proceed with caution, and we welcome the delay in implementing part of the new fiscal package until the latter half of 2001.

The change in the regional dynamics along with large international interests gives Macedonia a unique opportunity to develop in a positive way. It is important that it push ahead with structural reform and lay the foundation for sustained economic growth in order to make the most of these important opportunities.

Turning briefly to the Interim PRSP, I agree success would depend on the progress by the government in improving the institutions that enforce priorities with regard to policies and programs. To be effective, the PRSP requires a relatively powerful full time coordination unit located either in the

Ministry of Finance or perhaps the Prime Minister's office. Even if a specialist unit is set up, it is unlikely that they will manage to finalize the PRSP within the next couple of months as proposed. It is important that the Fund and the Bank are sensitive to the capability of the government in this kind of enterprise. In any event, it is important that ways are found to establish genuine government ownership of the PRSP. I detect a slight distance of the government from the I-PRSP in my perusal of the paper. I have some detailed comments on the PRSP which I will pass on bilaterally to staff.

Like others, I was surprised at the use of PRGF resources as proposed. I think comments may be slightly overblown, but I would be interested to hear the staff's explanation, which I am sure will be extremely convincing.

Finally, I am interested to know whether there has been progress in resolving the Article VIII difficulty which took up much of the Board discussion at the recent Article IV meeting.

Mr. Fenton made the following statement:

Taking into account events in the region in recent years and the important policy actions implemented by the Former Yugoslav Republic of Macedonia this year, we can support the proposed arrangements, although we share the concerns about the use of PRGF resources raised by other chairs.

I would like to make a few comments on the proposed program for emphasis, however. In particular, I would like to underscore the importance of making significant progress in the areas of governance and public expenditure management. I was concerned to read in the Memorandum of Economic and Financial Policies that some line ministries have recruited staff without budgetary authorization and accumulated arrears to suppliers this year. This should be stopped. A transparent centralized budget allocation process should be instituted as quickly as possible with all relevant government entities made subject to the process. And the authorities should proceed with their plan for divesting noncore activities that are a source of special off-budget revenues for line ministries.

I also agree with staff that priority should be given to reducing the public sector wage bill while improving the structure of wages in the public sector. I note that paragraph 19 of the MEFP mentions the possibility of a general public sector wage increase in 2001 if room is created within the wage ceiling through deeper job cuts. I do not think that this would be an appropriate use of these resources. The problem is not that the average wage in the public sector is too low. The problem is that the wage structure is too compressed with workers with more human capital or greater managerial responsibilities being underpaid relative to their private sector counterparts.

This is the problem that should be addressed with funds freed up by faster civil service reform.

I also agree with the focus on improving the targeting of social programs.

On the issue of monetary policy and the exchange rate target, we agree with maintaining the de facto exchange rate anchor for the time being, while the groundwork is laid for a transition to a flexible exchange rate regime. However, within this context, strict enforcement of supervisory guidelines and prudential regulations in the banking system is essential. Macedonia should strive to avoid the problems that have arisen in other countries where unsustainable exchange rate pegs have interacted with weak banking systems to create financial crises.

With respect to the interim-PRSP and ultimately the PRSP, we agree with Mr. Weisman and Mr. Collins on the importance of establishing clear priorities based on the impact of various policies on poverty reduction. We also strongly encourage the authorities to conduct a broadly-based participatory process in elaborating the full PRSP.

Mr. Costa made the following statement:

The programs approved today will create the necessary conditions for private capital flows which will meet the financial needs of the FYRM in the future.

However, numerous and significant efforts are needed in the area of structural reforms. Reform of the banking system is crucial. The expectation should be that present regulations will be strictly enforced, while revised supervisory and prudential guidelines will be in place by June 2001. Sanctions should be applied to those banks that fail to meet their reserve requirements. These sanctions should include the removal of management and a cessation of banking activities, stopping short of closing those banks altogether. I wonder if the staff impressed on the authorities the likely need to adopt such an extreme measure. I would welcome the imposition of such sanctions and their assessment as a benchmark for the first program review.

In order to strengthen the banking system, it is necessary to foster a strong enterprise sector. The problems many enterprises have are caused to a large extent by the way privatization has taken place through employee and management buyouts. Awareness of this issue has led to the decision to avoid direct negotiations in future privatizations. In this regard, I wonder about the status of the amendment to the existing privatization legislation to implement the best practice privatization process, allowing for international public tenders, which is listed in the PRSP. I believe this measure would have a more significant impact on the financial discipline of the corporate sector than the otherwise welcome legislative framework concerning shareholder's rights recently introduced.

In order to increase the attractiveness to potential investors both domestic and foreign, it is critical that a drive to enact an association agreement with the EU be accelerated. In this context, I welcome Mr. Wijnholds' recent announcement. This could serve not only to overcome the limitations stemming from the small size of the Macedonian market, but more importantly, it could represent a clear incentive to advance the process of structural reforms which, in turn, is a precondition to reaping the full benefits of enlarged markets.

Finally, on the I-PRSP paper, my concern stems from the interplay between ethnic connections to poverty, the poor coordination among ministries involving the Poverty Reduction Strategy, and the high politicization of their administration. All of these factors could easily converge to make manifest in reality risk scenarios detailed in this staff assessment. In particular, public funds intended for poverty reduction should be closely monitored.

Mr. Hinata expressed concern about the PRGF eligibility issue. He suggested the possibility of access under the PRGF for the first year, and under the EFF for the second, given the World Bank's decision that no resources would be committed for 2001.

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

Let me begin by saying that the former Yugoslav Republic of Macedonia is already PRGF-eligible. At times, in some of statements, it sounded like Directors thought that the staff was proposing to make FYRM PRGF eligibile. Because they are already eligible, FYRM has the right to request a PRGF arrangement, so long as they meet all the policy conditions necessary for such arrangements. The staff obviously thinks they have met there conditions.

The World Bank intends to remove FYRM from the IDA eligibility list in July of 2001. That is an intention. They have not yet done so. It would be preferable to wait and see if the Bank decision is actually confirmed. In this connection, it must be noted that estimates of per capita income, which are based upon purchasing power parity calculations, are subject to substantial revisions. These considerations were among those that are the staff's view argued against proposing a decision now.

However, per capita income is not the only criterion the Bank uses in determining IDA eligibility. It also looks at creditworthiness, and even exempts certain small island economies from these criteria altogether. There are at least five economies that have higher per capita income than FYRM that are on the IDA eligibility list; in fact, some have per capita incomes more than twice the level of FYRM.

When the staff reconsiders the PRGF-eligibility list, which it was in the process of doing now, this review is conducted on a case-by-case basis, which has been the guidance from the Board. No formal criteria had been established by the Board for ESAF eligibility, the predecessor to the PRGF. Certainly, IDA eligibility is one factor, but there are countries on the PRGF list that are not IDA-eligible, and there are also countries on the PRGF list that the Bank does not have on the IDA list. The two lists do not now, and have not in the past, coincided perfectly one with another. FYRM is not an unusual circumstance.

Where does that leave us going forward? The staff is working on a paper to review the eligibility list for PRGF. Our view will likely be close to the view contained in the statement of Mr. Schlitzer. One would expect FYRM to graduate from the PRGF by the end of the three-year horizon of the proposed arrangement.

This would mean that the Fund would have an opportunity to confirm whether or not the Bank has removed FYRM from the IDA-eligibility list. It also would allow us to address comparability of treatment issues, particularly with respect to other former Yugoslav republics who either are now PRGF-eligible or some other such countries that are not eligible at the present time but who might become PRGF-eligible. We also have to confirm that the calculations of per capita income are accurate. Owing to these considerations, the staff would not want to consider FRYMs PRGF eligibility at this time.

One point I would like to raise concerns Mr. Schlitzer's statement about the full cross-conditionality between the two arrangements. There is not full cross-conditionality between the two arrangements in the following sense: The EFF arrangement has quarterly performance criteria, and the PRGF has semi-annual performance criteria. Thus, it is conceivable that Macedonia could perform and purchase under the EFF and that purchase would be separate and independent of any developments under the PRGF.

It is also the case that program reviews of both arrangements are simultaneous, so that if a program review is not completed for a PRGF arrangement, it would not be completed for the EFF arrangement. In that sense, the two arrangements have full cross-conditionality.

The staff representative from the European I Department commented that the evidence presented on the private savings rate in table 6 and the tax table on page 14 suggested that there had been a large number of exceptional purchases of consumer durables in the first quarter of 2000, ahead of the introduction of the VAT in April 2000. A large amount of these expenditures had been financed by drawing upon savings that the population held in foreign currency deposits outside the banking system. By the second quarter, there was evidence that the savings and investment rates were returning to normal levels. It was expected that similar rates would carry over into 2001, and that the data would indicate a large pickup in private savings relative to 2000. In addition, if the government were to reduce the employee withholding tax in 2001 as planned, which was designed primarily to benefit the employer, corporate savings would improve giving another boost to the private savings ratio. Such considerations underlined the staff's support of the proposed program.

Nonetheless, given the risk that private savings might not be forthcoming, safeguards were put in place, the staff representative said. If, by the time of the program review, information on developments regarding the current account and the foreign exchange reserves were not in line with expectations, a decision would be made whether to introduce the second stage of fiscal policy measures.

On the question from Mr. Lehmussaari and Mr. Fidjestol on the rationale for the pre-payment of government debt to the commercial banking sector and households, the staff representative pointed out that there had been tremendous political pressure on the government to spend the surplus. The authorities had heeded staff advice and had resisted expenditures, which could become cyclically permanent. They authorities had to shift funds from the central bank toward commercial banks and the non-banking sector. This had a potential liquidity impact and the government recognized that this meant monetary policy might have to step in to reduce liquidity. The rationale was not justified in terms of interest costs: it was true that prepayment of the debt to commercial banks and to the household sector would reduce interest costs of the government. A at the same time, however, the commercial banks' interest for market operations would increase making their profitability and their transfers to the central bank lower. This would reduce central bank profits and therefore the holdings of the government. Therefore, in the end, the reduction of interest cost would be matched by a reduction in central bank profits.

On the question of the cause of recent improvements of banks' lending activities, and the related question by Mr. Weisman on additional likelihood of foreign participation in the banking sector, two factors had been responsible, the staff representative remarked. The largest commercial bank had been sold to a large bank from Greece, with participation by the IFC and the EBRD. Second, the monitoring of the banks had been strengthened, especially with regard to off-balance sheet items of commercial banks. It had been likely that foreign participation in the banking sector would increase with numerous purchases already in progress.

On the capital adequacy ratio of banks, the staff representative pointed out that eight banks had been classified as problem banks, which had resulted in ratings of four or five. Before Stopanska Banka had been sold, its capital adequacy ratio had been 6.5 percent as opposed to the Basle Accord guidelines of 8 percent of risk weighted assets. But after the sale of Stopanska Banka, the capital adequacy ratio had risen to 12.6. The second largest Bank had a ratio of 24, and all the smaller banks in Macedonia had capital adequacy ratios of more than 30. In part, that reflected that the smaller banks were unable to attract deposits and did not have substantial lending activities.

On the social impact of the sale of the public enterprises, the staff representative remarked that the net value of many of these companies was negative. Therefore, it was not surprising that, even with a 95 percent discount in some cases, there had been no bids. If enterprises were sold, the government had tried to protect employment by extracting commitments from buyers to retain employees for at least a two-year period. If enterprises were closed, the severance cost of laying off the workers was covered by a World Bank social support loan.

On subscription to the GDDS, the staff representative confirmed that the authorities now had said that they were ready to participate beginning in June 2001.

On the question of how much progress had been made on the Article VIII, the staff representative answered that the staff was still in the process of gathering information.

The amendment to the privatization law had taken place, the staff representative remarked.

Mr. Hinata repeated his question about the possibility of an alternative program design.

The staff representative from the Policy Development and Review Department answered that the commitments that the Board would make would be for a three-year EFF arrangement and a three-year PRGF arrangement. The Fund could not cancel those arrangements. However, the member country could, of its own choosing, decide to cancel one or both of those arrangements.

Mr. Wijnholds made the following concluding statement:

> After the comprehensive answers given by the staff on the issues raised, I have very little to add. I think it has become clear that this government is strongly committed to structural change. A very important development was the coming into office of a new, young, and dynamic Minister of Finance who pushed ahead. One of the results has been quite extraordinary budgetary performance, which I think does show that after the deep downturn that was felt at the time of the Kosovo crisis in Macedonia, things can change quickly. Also, the Kosovo crisis turned out to be an unexpected boon to Macedonia with all the activity in that area, internationally, and I think it has given them a shot in the arm, which they are now utilizing quite well.

With regard to the PRGF, a lot has been said. It has been shown that this country has been eligible since 1993. Yet, I myself mentioned in my statement that it is a borderline case. I thought that it was a rather sophisticated approach to graduate a country through a blend of programs. That is not uncommon in the World Bank, and I think Mr. Collins had it right when he said that this is really not of great importance. We are, indeed, talking about only SDRs10 million. But I think it was more a question of principle for a number of Directors here.

On the matter of Article VIII, I was glad it did not come up again in this discussion. We spent an inordinate amount of time on it, and I wonder if pursuing matters to this level of detail is all that productive.

The staff is going to be in Macedonia again soon, looking at the 2001 budget, and I trust that Mr. Banerjee and his team will again work closely with the authorities as they have done in the past, and we look forward to a continuation of the good working relationship.

The Acting Chairman made the following summing up:

Executive Directors supported the authorities' request for three-year arrangements under the Poverty Reduction and Growth Facility (PRGF) and an Extended Arrangement. They commended the authorities on maintaining financial stability despite the difficult regional situation, and noted the pickup in economic activity since the end of the Kosovo crisis. Inflation was under control and external reserves had increased substantially. Several Directors expressed reservations regarding the provision of resources under the PRGF for the Former Yugoslav Republic of Macedonia, given that per capita GNP is almost twice the IDA eligibility limit, and that no IDA resources will be committed starting July 1, 2001. They emphasized that the approval of a three-year arrangement under the PRGF should not be seen as setting new criteria for PRGF eligibility.

Directors welcomed several steps taken to move ahead with structural reforms in 2000. In particular, they noted the successful introduction of the value-added tax (VAT), the sale of Stopanska Banka to strategic investors, the sale or closure of several large loss-making enterprises, and passage of key legislation to support reforms in the financial sector, social insurance system, and public administration. However, Directors stressed the importance of accelerating reforms in key areas, including the banking and enterprise sectors, and urged the authorities to firmly implement them in order to underpin high economic growth.

Directors emphasized the key role of fiscal policy in supporting financial stability and promoting structural change. They endorsed the authorities' cautious and phased approach of delaying tax cuts and spending on reforms until evidence of durability of the strong VAT performance was firm. They viewed the plan to reduce labor taxes as a priority to encourage job creation.

Directors also emphasized that expenditure restraint would be needed to create adequate room for tax cuts. They stressed the need to persevere with downsizing of the civil service, divesting of non-core government activities, and eliminating surplus positions as a result of the consolidation of ministries. Directors welcomed the integration of off-budget special revenue accounts into the budget beginning in 2001 and the introduction of a fully operational central treasury system by end-2001. In this regard, they considered it important to improve fiscal transparency and governance.

Directors noted the progress made in strengthening bank supervision and the legal framework. They underscored the importance of enforcing supervisory guidelines and prudential regulations in the period ahead, and stressed that banks not in compliance with guidelines should be subject to prompt corrective action.

Directors observed that a concerted effort by the authorities was required to restructure enterprises and to improve corporate governance. In particular, they urged the authorities to implement various laws on bankruptcy and creditors' rights. Given the poor financial state of many loss-making enterprises, closure of some enterprises is likely to be needed. They welcomed the arrangements in place to cushion the impact on displaced workers because of enterprise restructuring.

Directors welcomed the authorities' intention to subscribe to the GDDS beginning in June 2001.

Directors endorsed the government's Interim Poverty Reduction Strategy Paper and agreed that it provided a sound basis for the development of a full, participatory PRSP and concessional support from the Fund under the PRGF. They noted that the full PRSP would need to include detailed action plans on protecting the interests of the most vulnerable groups and improving targeting of social programs, while prioritizing expenditures for poverty reduction projects.

The Executive Board took the following decisions:

Extended Arrangement

1. The government of the former Yugoslav Republic of Macedonia has requested an extended arrangement for a period of three years in an amount equivalent to SDR 24.115 million.

2. The Fund approves the arrangement set forth in EBS/00/231, 11/15/00, and decides that purchases may be made under the arrangement on the condition that the information provided by the former Yugoslav Republic of Macedonia on the implementation of the measure referred to in the first paragraph of the letter by the Minister of Finance and the Governor of the National Bank of the former Yugoslav Republic of Macedonia dated November 15, 2000, and further specified in paragraph 7 of the Memorandum of Economic and Financial Policies for 2000–03 attached to that letter, is accurate.

Decision No. 12336-(00/117), adopted
November 29, 2000

Poverty Reduction and Growth Facility Arrangement—Three-Year Arrangement

1. The government of the former Yugoslav Republic of Macedonia has requested a three-year arrangement under the Poverty Reduction and Growth Facility in an amount equivalent to SDR 10.335 million.

2. The Fund determines that the Interim Poverty Reduction Strategy Paper (I-PRSP) for the former Yugoslav Republic of Macedonia set forth in EBD/00/96, provides a sound basis for the development of a fully participatory PRSP and for Fund concessional financial assistance.

3. The Fund adopts the following decision in principle, which shall become effective on the date on which the Fund decides that the World Bank has concluded that the I-PRSP submitted by the former Yugoslav Republic of Macedonia provides a sound basis for the development of a fully participatory PRSP and for World Bank concessional financial assistance:

The Fund approves the arrangement set forth in EBS/00/231, 11/15/00, and decides that the former Yugoslav Republic of Macedonia may request disbursements under the arrangement, on the condition that the information provided by the former Yugoslav Republic of Macedonia on the implementation of the measure referred to in the first paragraph of the letter by the Minister of Finance and the Governor of the National Bank of the former Yugoslav Republic of Macedonia dated November 15, 2000, and further specified in paragraph 7 of the Memorandum of Economic and Financial Policies for 2000–03 attached to that letter, is accurate.

Decision No. 12337-(00/117), adopted
November 29, 2000

4. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mrs. Hetrakul on the completion of her service as Executive Director for Brunei Darussalam, Cambodia, Fiji, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Nepal, Singapore, Thailand, Tonga, and Vietnam.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/00/116 (11/27/00) and EBM/00/117 (11/29/00).

5. GUYANA—POVERTY REDUCTION AND GROWTH FACILITY—SECOND ANNUAL ARRANGEMENT; AND ENHANCED INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—DECISION POINT

1. Pursuant to the decision of November 13, 2000 (EBS/00/2 13), paragraph 3, and the decision of November 13, 2000 (EBS/00/214, Sup. 1, Rev. l), paragraph 3, the Fund notes that the World Bank has concluded that:

(a) the Interim PRSP provides a sound basis for the development of a fully participatory PRSP, for reaching the decision point under the enhanced HIPC Initiative, and for World Bank continued concessional assistance.

(b) Guyana has reached its decision point under the enhanced HIPC Initiative.

Accordingly:

2. Paragraph 3 of the decision set forth in EBS/00/213 and paragraph 1 of the decision set forth in EBS/00/214, Supplement 1, Revision 1, shall become effective on the date of this decision.

Decision No. 12338-(00/117), adopted
November 28, 2000

6. REVIEW OF FUND FACILITIES

Supplementary Reserve Facility and Contingent Credit Lines—Amendments to Decision

Decision No. 11627-(97/123) SRF, adopted December 17, 1997 shall be amended as follows:

1. Paragraph 13 shall be amended to read as follows:

"13. Through November 30, 2003, the Fund will be prepared to commit and provide financial assistance to a member under the terms and conditions specified in this section."

2. Paragraph 17 shall be amended to read as follows:

"17. The Fund may commit resources under this section at any time under an arrangement, but will only make such resources available after the completion of an activation review under the arrangement when it finds that the member meets the conditions specified in paragraph 15. The arrangement will specify the total amount of resources committed under this section and the amount of such resources that will be made available upon the completion of the activation review. The availability of the rest of the committed resources under this section shall be subject to such phasing and conditionality as the Fund shall consider appropriate, normally at the time of a post-activation review. In addition, the arrangement will normally provide for the continued commitment of resources under this section beyond a specified date to be subject to the completion of a program review by the Fund. The Fund may commit resources under this section for a period of up to one year and, after it makes such resources available, may extend such period for up to one year from the date such resources are made available."

3. Paragraph 19 shall be amended to read as follows:

"19. Paragraphs 6, 7, 10 and 11 of this decision shall apply to purchases made under this section."

4. Paragraph 20 shall be amended to read as follows:

"20. During the first year from the date of the first purchase financed under this section, the rate of charge under Article V, Section 8(b) on holdings acquired as a result of purchases under this section shall be 150 basis points per annum above the rate of charge referred to in Rule I-6(4) as adjusted for purposes of burden sharing. Such rate shall be increased by 50 basis points at the end of that period and every six months thereafter, until the surcharge reaches 350 basis points, subject to the provisions of paragraph 21."

5. The following new paragraph 21 shall be added:

"21. The provisions of Decision No. 8165-(85/189) G/TR, December 30, 1985, except section IV, shall apply to overdue obligations arising under this section, subject to the following provision:

The rate of charge on overdue repurchases shall be determined by the Fund but shall not be less than the maximum rate of charge specified in paragraph 20."

6. The following new Paragraph 22 shall be added:

"22. This section and its operation will be reviewed no later than November 30, 2002."

Decision No. 12340-(00/117) SRF/CCL, adopted
November 28, 2000

Conversion of Emergency Assistance into Special Policy

1. The Fund will be prepared to provide financial assistance to members who are afflicted by natural disasters or are in post-conflict situations. This assistance will be provided in accordance with the provisions of this decision and the guidelines on emergency assistance for natural disasters and post-conflict situations set out in: (i) pages 17 and 18 of EBM/82/16 (2/10/82); (ii) *Summing Up by the Chairman – Fund Involvement in Post Conflict Countries - Executive Board Meeting 95/82- September 6, 1995* (BUFF/95/98 (9/19/95)); and (iii) *Summing Up by the Acting Chairman – Fund Assistance to Post-Conflict Countries – Executive Board Meeting 99/38 – April 5, 1999* (BUFF/99/48 (4/9/99)).

2. Purchases under this decision and holdings resulting from such purchases shall be excluded for the purposes of the definition of reserve tranche purchase pursuant to Article XXX(c).

3. Except for the purpose of determining the level of conditionality applied to purchases in the credit tranches, the Fund's holdings of a member's currency resulting from purchases under this decision shall be considered separate from the Fund's holdings of the same currency resulting from purchases under any other policy on the use of the Fund's general resources.

4. In order to carry out the purposes of this decision, the Fund will be prepared to grant a waiver of the limitation of 200 percent of quota in Article V, Section 3(b)(iii), whenever necessary to permit purchases under this decision or to permit other purchases that would raise the Fund's holdings of the purchasing member's currency above that limitation because of purchases outstanding under this decision.

Decision No. 12341-(00/117), adopted
November 28, 2000

Repurchases Under Emergency Assistance; Purchases in Credit Tranches and Compensatory Financing Facility—Repurchase Expectations

1. Decision No. 5703-(78/39), adopted March 22, 1978, shall be amended as follows:

(i) paragraph 1(a) shall be amended by adding: "or the decision on Emergency Assistance (Decision No.)," before "shall be completed";

(ii) the current paragraph 1(b) shall be deleted in its entirety and replaced by the following:

"(b) A member will be expected to repurchase the Fund's holdings of its currency resulting from purchases in the credit tranches or under the Compensatory Financing Facility made after November 28, 2000 in equal quarterly installments during the period beginning two years and ending four years after the date of the purchase, provided that the Fund may, upon request by the member, amend the schedule of repurchase expectations, if in the judgment of the Fund the member's external position is not sufficiently strong for repurchases to be made in accordance with the expectation schedule set out in this paragraph. In determining whether to amend the schedule, the Fund may consider all relevant information, including the size of the member's foreign reserves, the member's medium-term balance of payments outlook, and the degree of the member's access to international capital markets.";

and

(iii) the following new paragraph 1(c) shall be added:

"(c) The Fund shall not approve, and the Managing Director shall not recommend for approval, any request for the use of the Fund's general resources by a member that is failing to meet a repurchase expectation under paragraph 1(b) above. Provision shall be made in each stand-by and extended arrangement for the suspension of further purchases under the arrangement whenever a member fails to meet a repurchase expectation under paragraph 1(b) above."

2. The Fund shall review the time-based repurchase expectation scheme set out in paragraph 1(b) of Decision No. 5703-(78/39), adopted March 22, 1978, no later than November 30, 2005.

Decision No. 12342-(00/117), adopted
November 28, 2000

Extended Fund Facility—Repurchase Expectations

1. Decision No. 4377-(74/114), adopted September 13, 1974, shall be amended by adding the following new paragraph:

"10. (a) In addition to making repurchases in accordance with paragraph 5, a member will be expected to repurchase an amount of the Fund's holdings of its currency resulting from purchases under this decision made after November 28, 2000 equal to, and at the time of, the six-monthly installments of repurchases falling due during the period beginning four years and ending seven years after the date of the purchase, provided that the Fund may, upon request by the member, amend the schedule of repurchase expectations, if in the judgment of the Fund the member's external position is not sufficiently strong for repurchases to be made pursuant to the expectation schedule set out in this paragraph. In determining whether to amend the schedule, the Fund may consider all relevant information, including the size of the member's foreign reserves, the member's medium-term balance of payments outlook, and the degree of the member's access to international capital markets.

(b) The Fund shall not approve, and the Managing Director shall not recommend for approval, any request for the use of the Fund's general resources by a member that is failing to meet a repurchase expectation under paragraph 10(a) above. Provision shall be made in each stand-by and extended arrangement for the suspension of further purchases under the arrangement whenever a member fails to meet a repurchase expectation under paragraph 10(a) above."

2. The Fund shall review the time-based repurchase expectation scheme set out in paragraph 10(a) of Decision No. 4377-(74/114), adopted September 13, 1974, no later than November 30, 2005.

Decision No. 12343-(00/117), adopted
November 28, 2000

Poverty Reduction and Growth Facility—Nonapproval of New Arrangements Under Poverty Reduction and Growth Facility (PRGF) and Suspension of Loan Disbursements Under Existing PRGF Arrangements Whenever Member is Not Meeting Repurchase Expectation

The Instrument to Establish the Poverty Reduction and Growth Facility annexed to Decision No. 8759-(87/176) ESAF shall be amended by adding the following at the end of paragraph 1(e) of Section II:

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

Decision No. 12344-(00/117)PRGF, adopted
November 28, 2000

Attribution of Repurchases Made to Meet Time-Based Repurchase Expectations

Decision No. 6831-(81/65), adopted April 22, 1981, shall be amended as follows:

1. Paragraph 1(a) shall be amended to read as follows:

"(a) Subject to paragraphs (b), (c), (d) and (e) below a member shall be free to attribute a reduction in the Fund's holdings of its currency (i) to any obligation to repurchase, and (ii) to enlarge its reserve tranche."

2. The following new paragraphs 1(d) and 1(e) shall be added:

"(d) A reduction resulting from a repurchase made pursuant to a repurchase expectation under paragraph 1(b) of Decision No. 5703-(78/39) shall be attributed to the member's repurchase obligation arising from the same purchase one year after the original date on which that repurchase expectation was to be met.

(e) A reduction resulting from a repurchase made pursuant to a repurchase expectation under paragraph 10(a) of Decision No. 4377-(74/114) shall be attributed to the member's repurchase obligation arising from the same purchase three years after the original date on which that repurchase expectation was to be met."

Decision No. 12345-(00/117), adopted
November 28, 2000

Surcharge on Purchases in Credit Tranches and Under Extended Fund Facility

1. The rate of charge under Article V, Section 8(b) on the Fund's combined holdings of a member's currency in excess of 200 percent of the member's quota in the Fund resulting from purchases in the credit tranches and under the extended Fund facility made after the date of this decision shall be 100 basis points per annum above the rate of charge referred to in Rule I-6(4) as adjusted for purposes of burden sharing, provided that the rate on such holdings in excess of 300 percent of the member's quota shall be 200 basis points per annum above the rate of charge referred to in Rule I-6(4) as adjusted for purposes of burden sharing.

2. This decision shall be reviewed after November 30, 2004.

Decision No. 12346-(00/117), adopted
November 28, 2000

Changes to Commitment Charge—Stand-By and Extended Arrangements

Rules I-8(a) and I-8(b) of the Rules and Regulations shall be amended to read as follows:

"(a) A charge shall be payable at the beginning of each twelve-month period ("the relevant period") of an arrangement as follows:

(i) ¼ of 1 percent per annum on amounts of up to 100 percent of the member's quota that could be purchased during the relevant period; and

(ii) 1/10 of 1 percent per annum on amounts in excess of 100 percent of the member's quota that could be purchased during the relevant period.

(b) When a purchase is made under an arrangement, the amount of the charge paid shall be reduced, and a refund equal to the reduction shall be made, as follows:

(i) to the extent that purchases during the relevant period do not exceed 100 percent of the member's quota, the portion of the charge calculated in accordance with subparagraph (a)(i) above shall be reduced by the proportion that the amount of the purchase bears to the amount of the arrangement not exceeding 100 percent of the member's quota that could be purchased during the relevant period; and

(ii) to the extent that purchases during the relevant period exceeds 100 percent of the member's quota, the portion of the charge calculated in accordance with subparagraph (a)(ii) above shall be reduced by the proportion that the amount of the purchase bears to the amount of the arrangement exceeding 100 percent of the member's quota that could be purchased during the relevant period."

Decision No. 12347-(00/117), adopted
November 28, 2000

7. APPROVAL OF MINUTES

The minutes of Executive Board meetings 00/52 and 00/56 are approved.

APPROVAL: September 7, 2001

SHAILENDRA J. ANJARIA
Secretary