October 23, 1997
Approval: 10/30/97

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/26

10:00 a.m., March 21, 1997

Contents

Decision Taken Since Previous Meeting

Executive Board Attendance
M. Camdessus, Chairman
A.D. Ouattara, Acting Chairman
S. Sugisaki, Acting Chairman

Executive Directors	Alternate Executive Directors
	S.M. Al-Turki
	J.G. Borpujari, Temporary
	O. Himani, Temporary
M.-A. Autheman	A. Fayolle
	J. Chelsky, Temporary
B. Esdar	W.-D. Donecker
	N. Coumbis
	J.N. Santos, Temporary
D.Z. Guti	J.M. Jones, Temporary
D. Kaeser	W.K. Gruber, Temporary
	O. Issaev, Temporary
A. Kafka	H. Mori, Temporary
W. Kiekens	D.A.A. Daco, Temporary
	J. Hamilius, Temporary
	M. Nemli, Temporary
K. Lissakers	B.S. Newman
	M.A. Brettschneider, Temporary
	T. Schneider, Temporary
	M. Daïri
	M.-H. Mahdavian, Temporary
	A. Vernikov
	L. Palei, Temporary
	J. Shields
	M.A. Brooke, Temporary
A.S. Shaalan	Y.Y. Mohammed
	G.M. Iradian, Temporary
	H.B. Disanayaka
	R. Kannan, Temporary
	V. Trivedi, Temporary
	R.P. Watal, Temporary
E. Srejber	B. Andersen
	A. Lucenti, Temporary
E.L. Waterman	
	Y.G. Yakusha
	J.P. Leijdekker, Temporary
K. Yao	A. Barro Chambrier
	B. Konan, Temporary
	D. Saha, Temporary
Y. Yoshimura	H. Ogushi, Temporary
	S. Fukushima, Temporary
	Y. Tahara, Temporary
Zamani A.G.	S. Joyosumarto
	Phan M.H., Temporary
	Han M.
	He J., Temporary
	Huang X, Temporary
A.G. Zoccali	O. Otazú, Temporary

R.H. Munzberg, Secretary
W.S. Tseng, Acting Secretary
P. Cirillo, Assistant
M. Cuc, Assistant

Also Present

IBRD: M.R. Andrade, R.R. Blake, K. Ohashi, Africa Regional Office; I. Bannon, Latin America and the Caribbean Regional Office; A. Farah, Middle East and North Africa Regional Office; M. Riboud, Europe and Central Asia Regional Office. African Department: E.A. Calamitsis, Director; A. Basu, Deputy Director; P. Dhonte, Deputy Director; G.E. Gondwe, Deputy Director; E. Hernández-Catá, Deputy Director; A.I. Abdi, P.A. Acquah, B.F.W. Bingham, D.T. Coe, K. Driessen, C.A. François, E.C. Harris, H. Hino, X. Maret, E. Sacerdoti. Asia and Pacific Department: D.J. Goldsbrough, M.R. Kelly. European II Department: M. Castello-Branco, T. Catsambas, N.A. Hobdari, I. Kapur, J. Márquez-Ruarte, G.C. Pastor, M. Shadman-Valavi. External Relations Department: S.J. Anjaria, Director; G.V. Bhatt. Fiscal Affairs Department: I.C. Lienert, A.J. Pellechio. Legal Department: W.E. Holder, Deputy General Counsel; P. De Boeck, J.M. Ogoola. Middle Eastern Department: P. Chabrier, Director; S. Chami, H.E. Jakubiak, A.H. Mansur, E.K. Martey, K. Nashashibi, K.I. Sakr, C. Sassanpour, V.Treichel. Policy Development and Review Department: J.T. Boorman, Director; T. Leddy, Deputy Director; D.J. Andrews, J.W. Decressin, U. Erikson von Allmen, O. Havrylyshyn, J.P. Pujol. Secretary's Department: P. Gotur, A. Mountford, M.J. Miller. Treasurer's Department: D. Gupta, Deputy Treasurer; C.A. Hatch. Western Hemisphere Department: C.M. Loser, Director; M.E. Bonangelino, Deputy Director; J.A. Gons, S.P.O. Itam, A.S. Linde, C.A. Paiva, L. Schmitz, M. Torres, G. Yadav. Regional Office for Asia and the Pacific: K. Saito, Director; C.J.R. Morris. Office of the Managing Director: J.A. Quick, Personal Assistant; J.A. Clément, L.A. Wolfe. Advisors to Executive Directors: M. Askari-Rankouhi, L.J.F. Erasmus, S.S. Farid, A. Giustiniani, C.M. Gonzalez, A. Levy, O. Sein, M. Sobel, T. Turner-Huggins. Assistants to Executive Directors: W.F. Abdelati, J.A. Akhmetova, T. Berrihun, N.R.F. Blancher, M.A. Cilento, C.K. Duenwald, J.C. Estrella, L. Fontaine, B. Grikinyté, R.J. Heinbuecher, J.K. Honeyfield, H. Javaheri, M. Kell, B. Killen, E. Kouprianova, T.-M. Kudiwu, D.G. Loevinger, B.M. Lvin, M.Z. Maatan, J. Mafararikwa, I. Moon, A.R. Palmason, J.L. Pascual, L. Pinzani, T. Presečan, E.T. Rădulescu, J. Roaf, O. Schmalzriedt, Song J., U.Y. Tilyayev, M. Vismantas, A.G. Yakub, M. Yiu, Zheng H.

1. REGIONAL OFFICE FOR ASIA AND THE PACIFIC—STATEMENT BY MANAGING DIRECTOR

The Managing Director made the following statement:

Before we start with the agenda of the day, I would like to say a few words about the idea of creating a new Regional Office for Asia and the Pacific, an idea I announced in late November 1996 to the Executive Board.

You are aware of our strategy for Asia and the Pacific and the related changes to the organizational structure of the Fund. All of these changes were designed to take account of the substantial and growing importance of the economies of the region in the global economy, and the changes included the establishment of a Regional Office for Asia and the Pacific.

During the discussion that followed, I indicated that a decision as to the location of the Office would be made early in 1997, and I was impressed and, indeed, pleased that this administrative decision had raised interest among the members of the Board, many of you kindly letting me know your suggestions and preferences. Of course, this has helped me in coming to a conclusion, which I would like to share with you today.

But before doing this, let me briefly report on the selection process that management and the staff followed over the last few months. Almost immediately after the announcement last November, I was surprised to have an avalanche of candidacies, and, in particular, five cities expressed willingness to host the Office: Hong Kong, Kuala Lumpur, Phnom Penh, Singapore, and Tokyo.

In response, the staff first reviewed on the basis of information available in Washington, the transportation and communication facilities and more generally the ease of conducting business in each city. This review indicated that Phnom Penh, in spite of the particular charm of this city, could not be seen as on a par with the other cities.

Subsequently, in mid-January 1997, a mission visited the remaining four cities to assess more closely their suitability as a site of the Office. In each of these four cities, the mission met with senior officials and gathered a good deal of pertinent information regarding the operation and cost of an office. This included information relevant to the Office's future activity, such as the size of the international financial and diplomatic communities, and information on the cost of office space, residential housing, and local support staff. The mission also received information from each of the authorities as to the possible cost-sharing arrangements that might be put in place were that city chosen as the location of the Office.

Since the mission returned to headquarters in late January, some follow-up discussions took place to clarify certain elements of these arrangements. I have been, I must say, encouraged by the support that our new initiative has received. We have also given careful consideration to the matter

of the Office's location, taking into account the objectives and expected requirements of the Office.

The primary aims of establishing this Office are to allow the Fund to develop closer ties with national policymakers in the region who have been working increasingly through various regional policy fora toward greater policy coordination and cooperation; to monitor economic development more closely; and to strengthen contacts with financial markets and the media in the region.

Cost considerations are another important element in determining the Office site, and in this context I am particularly appreciative of the willingness indicated by the authorities in each of the four locations we have visited to share in the cost of establishing and operating the Office. These offers deserve our deep gratitude.

Each of the cities is found to have both strengths and indeed weaknesses as a potential location for the Office. However, after careful consideration, we have come to the conclusion that Tokyo would be the most suitable location for the Office to meet its expected requirements. Tokyo is, of course, a key geopolitical, economic, and financial center, and the Japanese authorities are heavily involved in the work of many regional and international policy fora.

In addition, the Japanese authorities have an extensive program of technical assistance, and the Regional Office, in conjunction with the IMF Institute, could play an important role in helping to liaise with the authorities on this program, which we expect to amplify in the future.

Setting up and staffing the Office presents no significant obstacles in Tokyo with a large pool of bilingual support staff available. The costs of maintaining an office in Tokyo have been carefully analyzed, but will be offset in part by the cost-sharing arrangements that the Japanese authorities have proposed. All in all, these factors give Tokyo an edge over the other cities being considered.

Clearly, the activities of the Regional Office will cover more than those conducted at its office site in Tokyo. The staff of the Regional Office will make frequent visits to other key cities in the region to keep in close contact with the regional financial communities and to facilitate information-gathering and relationship-building, particularly with the financial centers.

In Singapore, they will also coordinate, in conjunction with the Institute, the discussions aimed at strengthening technical assistance activity in the region, a domain for which the Singaporean authorities have expressed a particular interest and sympathy, including the possible establishment of a regional training institute to which they are ready to contribute generously if we come to this decision.

Hong Kong will also be a place requiring our presence during the next few months with the preparation for the transition and the annual meetings. Beyond this, the Hong Kong authorities have expressed interest in as meaningful and permanent a Fund presence there as possible—to which we will come back later.

In all cities where the staff of the Regional Office are expected to make frequent visits, the authorities have kindly agreed to provide, free of charge, basic office facilities, including secretarial assistance. This has made it easier to find a proper solution to the issue I will mention now of the budgetary implications.

I mentioned last November that the cost of the new Office will be offset in our budget by savings in the Fund's expenditure elsewhere and the contribution, of course, of the national authorities. Within that framework, management has approved a staff of five people for the Office, including one engaged locally. And the Fund's administrative budget for fiscal year 1998 will include the estimated administrative expenses.

As for the cost of office space, the cost sharing arrangement offered by the Japanese authorities will remove the need for the Fund to pay rental and utility costs as well as the initial fit-out costs of the office. Excluding these costs for office space, the cost to the Fund of the Regional Office is estimated to be about $2 million per annum, about the same as the cost of the Geneva Office which is approximately the same size.

In addition, the Japanese authorities have offered to pay the cost of some consultants and their operational expenses if these consultants are engaged in agreed, appropriate activities, such as facilitating technical assistance or public relations work in the region. The details of this arrangement will need to be discussed with the Japanese authorities.

So what next? The staff will now start negotiating a headquarters agreement with the Japanese authorities, to which, indeed, we are extremely grateful for extending to us this generous hospitality. This will include, inter alia, the cost-sharing arrangements and the establishment of an account in the Fund to handle the authorities' financial contributions toward the cost of the Office. It will also cover the diplomatic privileges and immunities that the staff of the Office will have. These negotiations, when completed, will be followed by the physical establishment of the Office and staff relocation. If all goes well, the office in Tokyo is expected to be open for business by late August.

Further information on the specifics of the arrangements concerning the Regional Office will be made available to the Board in due course, and you will have in the budget for 1997–98 all the details of the cost and the way in which they are covered.

Mr. Yoshimura made the following statement:

I welcome the decision announced by the Managing Director to have the Regional Office for Asia and the Pacific located in Tokyo. I would like to take this opportunity to express my appreciation to my colleagues for their support.

As we have said on previous occasions, and as was explained by the Managing Director, the government of Japan will contribute financially toward the activities of the Regional Office for Asia and the Pacific. In addition, we are most willing to cooperate closely with the Office in various aspects of its activities.

In light of the importance of Asia and the Pacific, not only as far as its economies are concerned, but also because of its growing and diverse foreign financial markets, it is important for the Fund to enhance its role in surveillance in the region. Moreover, Fund cooperation with various international fora such as APEC and ASEAN is becoming more and more important. Therefore, the Regional Office will have a pivotal role in strengthening the Fund's role in the Asia-Pacific region.

I hope that the establishment of the Regional Office for Asia and the Pacific in Tokyo will be early and go smoothly and that the Office will make the most of its capacity, bearing in mind its growing role in Asia and the Pacific. The Japanese government will make its utmost effort to support this Fund initiative.

The Managing Director noted that the decision was agreeable to the Board and that the budgetary aspects would soon be communicated to the Board.

2. PANAMA—STAND-BY ARRANGEMENT—REVIEW, AND WAIVER OF PERFORMANCE CRITERIA

The Executive Directors considered a staff paper on the second review under the Stand-By Arrangement for Panama and its request for a waiver of performance criteria (EBS/97/31, 3/6/97; and Cor. 1, 3/20/97).

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

My Panamanian authorities appreciate the well-balanced report which the staff has prepared for the second review under the Stand-By Arrangement. The report reflects that economic and financial developments continued to be favorable during 1996, and testifies to the commitment of the authorities to macroeconomic stabilization and structural reform. Although my Panamanian authorities are requesting waivers for the nonobservance of some end-December 1996 performance criteria, progress under the Stand-By Arrangement continued to be satisfactory, and the pace of reform implementation has strengthened. Therefore, I am confident that my colleagues will be prepared to grant the waivers requested.

Real GDP growth was 2 percent in 1996, in line with the original program projection, and it is expected to accelerate to 3.5 percent in 1997, as a result of a boom in construction, better performance of the Colon Free Zone, and a continuing strong increase in the financial services sector. Inflation remained low in 1996, and is expected to track U.S. inflation in the period ahead.

On the fiscal front, the public sector surplus increased from 0.2 percent of GDP in 1995 to 0.4 percent of GDP in 1996. The improvement would have been close to the targeted surplus of 1 percent of GDP if there had not been extraordinary expenditures, i.e., severance payments of 0.4 percent of GDP to facilitate the leasing of ports to private firms. To compensate for this extraordinary payment and for a slight fall in the public enterprises' operating surplus, other government expenditures were kept below program targets. For 1997, however, some of the structural reforms will entail initial costs.

It is important to clarify that the planned privatization of certain public enterprises will initially have a negative net impact on public sector receipts since the privatized enterprises are profitable. Similarly, the liquidation of the Complementary Pension Fund (CPF) will involve an initial cost for the government, as it requires the buy-out of part of its contributors and entails a temporary increase in costs to the public sector of 0.5 percent of GDP per annum through the year 2002. Improved tax administration and expenditure control are expected partially to offset the initial costs of the reforms, while in the long run privatization is expected to contribute powerfully to increased profits of the enterprises.

On the external front, the current account improved significantly in 1996. The trade deficit remained stable but a significant improvement occurred in the services account as a result of interest rate relief on external debt, continued strong traffic through the Panama Canal, and an increase in tourist arrivals. However, in the medium term, the external current account deficit would widen, due to higher imports associated with trade reform and increased investment, and lower services receipts following the withdrawal of U.S. troops. But the deficit would decline to less than 3 percent of GDP by 2002, as a result of accelerating export growth, mainly reflecting a five-fold increase in copper and gold production and an evolving tourism sector.

In 1996, external debt restructuring prompted a 14 percent public debt reduction, from a stock of debt of $5,946 million in 1995, to $5,104 million. Also, the debt/GDP ratio declined from 72 percent to about 59 percent, and debt service as a percent of exports of goods and services declined about 7 percentage points, from 23 percent in 1995 to 16 percent in 1996. This restructuring included the settlement of arrears with Mexico and Venezuela totaling $308 million. Moreover, my authorities have resumed commercial borrowing by issuing a $500 million Eurobond with a five-year maturity, to buy back long-term public sector commercial debt.

On the structural front, the medium-term strategy includes trade, tax, public enterprises, social security, and financial sector reforms, together with

public sector wage bill restructuring. Trade protection has been reduced significantly, new legislation for private sector participation in public services has been passed, and the privatization program has been accelerated. Also, the recent legislative approval of the liquidation of the complementary pension fund for civil servants constitutes a very important step in the reform process. Moreover, in December 1996, draft legislation for Panama's accession to the WTO was approved by Cabinet and is scheduled for submission to the Legislative Assembly in March, with approval expected in the first half of 1997. The trade liberalization program is designed to reduce tariffs significantly, and it has already eliminated nontariff barriers, and established antitrust and antidumping provisions.

Changes are also planned in the financial sector where the banking law is being modernized to provide for better prudential control and supervision as well as to improve competitiveness of the banking sector. The second phase of the financial reform is expected to begin in the second half of 1997 and will focus on the modernization of regulations concerning the stock exchange and the insurance industry, and the restructuring or liquidation of state-owned banking institutions.

All in all, my authorities expect that these structural measures will contribute to a further increase in public sector savings from 2.8 percent of GDP in 1997, to almost 6 percent by the year 2002. Finally, my authorities wish to express their warm gratitude to the staff for their assistance.

Ms. Lissakers made the following statement:

I think that, overall, one can be quite satisfied with both the performance of the Panamanian economy and the broad progress that is being made on the modernization and reform effort on many fronts in Panama.

First of all, the debt restructuring agreement concluded last year was crucial in re-establishing Panama's external viability and renewing its access to international capital markets. Fiscal performance has also improved, with the principal balance moving to small surpluses in recent years. The increase in private investment in critical projects is also particularly important and an indicator that one can have some confidence in the continuation of improved performance.

GDP growth in 1995 and 1996 was not quite what one would have liked, but there does seem to be reasonable expectation of an improvement and more rapid growth this year, while inflation remains low. Lower interest payments from debt restructuring and control over current expenditures allowed Panama to maintain an overall public sector surplus of 0.4 percent last year. Future savings can be expected from the decision to liquidate the complementary pension fund for civil servants. We think this was a bold and highly desirable move on the part of the authorities. Trade liberalization and continued divestiture of state enterprises will enhance efficiency gains, boost competitiveness, and add fuel to private sector growth.

We therefore support the completion of the second review of Panama's Stand-By Arrangement. Nevertheless, there are some cautionary notes to sound about the fiscal outlook. The authorities propose to raise public sector spending, leading to fiscal deficit of almost 1 percent this year, against a backdrop of declining state enterprise revenues, fiscal burdens of structural reform, the severance pay liquidation of pension scheme, and so on—and, for the immediate term, perhaps a decline in tariff revenue as trade liberalization proceeds. Obviously, there will be gains down the road from these measures, but there is also an immediate fiscal impact.

There should be additional effort on the revenue side to find alternative sources of revenue to give a little more room to accommodate necessary public spending. The comprehensive tax reform should, therefore, be a priority, including development of a broad-based indirect tax. Reducing the size of the civil service is also clearly necessary.

I wonder, on the revenue front, whether the staff can give us some indication of the impact of the authorities' proposed closing of various tax loopholes and the updating of the assessment base, and what magnitude of improvement in revenue they expect to have from that.

On the investment front, we commend the authorities for clearing the way for privatization of the electricity and water sectors. Having full divestiture of INTEL would be preferable to the auction of only 49 percent of equity, however. I wonder if the staff could update us on the plans to further reduce the state's stake in this company.

Taken together with the opportunities available from the reversion of U.S. bases in the Canal Zone, there should be increased momentum for private investment. However, if these in-flows are to be sustained over the longer term, the legal and regulatory framework for investment needs improvement. Panama must ensure fair, transparent, and uniform applications of laws, regulations, and procedures affecting investors, including foreign investors. This is particularly true for the bidding process, which has not always met the highest international standards in the past.

It is gratifying to see that the authorities are moving forward on financial sector reform. The financial sector is a very large part of the Panamanian economy. There have been some weaknesses in it, both in the framework and in the institutions themselves. We are pleased to see that the authorities plan to push ahead with strengthening banking supervision and also in developing the domestic debt market, which will create alternative financial instruments.

Finally, there has been progress on money laundering, and we hope to see more effective enforcement of Panama's money laundering laws in the future. The Panamanian offshore market should be considered a sound market for honest investment, not a place to launder ill-got gains.

Mr. Esdar made the following statement:

We first like to commend the staff for providing us with an excellent paper. I especially found the boxes very helpful. We very much welcome that Panama in the recent past has come much closer to a viable external position. Besides the quite supportive effects of the restructuring of external debt, it has been also the strong adjustment policies implemented by the authorities which deserve the credit for the favorable economic performance. Especially noteworthy seem to be their strategies of downsizing the public sector and liberalizing external trade. The regained access to international financial markets at quite attractive conditions is the result of this overall positive performance. Also, the increase in private investment reflects growing confidence in Panama. However, at the same time it is important not to loose momentum in the adjustment efforts ahead.

Due to the constraints given by the choice of the monetary and exchange rate regime fiscal and structural policies are the main policy instruments which have to bear the major adjustment burden. They must be used vigorously to deal with the upcoming challenges, especially with respect to achieving a sustainable fiscal situation and to strengthening the basis for sustainable growth. I share Ms. Lissakers's view that the envisaged tax reform and the continuation of the restructuring of the financial sector are crucial in this regard.

Since we agree with the thrust of the staff's analysis and recommendations and support the proposed decision, I would only like to comment briefly on two issues.

First, on the fiscal reforms in 1997. The staff has noted that the authorities are working on the improvement of expenditure control and cash management along the lines recommended by the Fiscal Affairs Department. We fully support these efforts. However, with respect to the planned abolishment of the carry-over of unused budgetary allocations into the subsequent year (p. 17, para. 27) I should like to voice some caution.

While we agree that such a step would increase transparency and accountability, restrictions on carry-overs of unused funds have caused a "spending fever" at the end of the budget period in some countries, when remaining funds are spent only to meet the deadline in order to avoid cuts in the allocation of funds in the subsequent year.

Secondly, according to the staff report, the authorities are interested in a successor arrangement with the Fund. While we noted that the Fund's exposure to Panama is only limited, we also have to take into consideration the strengthened external position of Panama and the fact that Panama has had financial arrangements with the Fund for quite some time. Therefore, I wonder whether a precautionary Extended Fund arrangement or an arrangement with only a small access volume might be an appropriate basis to support the authorities in their further reform efforts.

With these remarks we wish the authorities all the best in their endeavors.

Mr. Otazú made the following statement:

With the support of the Fund, the World Bank and the IDB, Panama has adopted comprehensive reforms aimed at deregulating and modernizing its economy. In 1996, performance under the 16-month Stand-By Arrangement was broadly satisfactory, and relative price stability was achieved. Economic growth was moderate and there was an increase in unemployment. At the same time, substantial progress was made in the structural area, particularly in reducing protectionism in agriculture and manufacturing, increasing the efficiency of the port system, and in developing an incentive structure aimed at fostering investment in mining, tourism, manufacturing, utilities, ports, and transportation.

Because my own position is generally in line with the staff appraisal, I will focus on fiscal and financial performance and the structural challenges facing Panama. The authorities have demonstrated a commitment to fiscal consolidation—which has been under way for some time—and external financial relations have been normalized as a consequence of the debt restructuring process in 1996. However, the loss in revenue attributable to the departure of U.S. servicemen and the temporary decline in activity in the Colon Free Zone will demand rapid implementation of certain revenue measures and other public sector reforms. These are essential to make room for needed investments in basic infrastructure and human services and to ensure a rising level of national savings over time.

On the structural front, the government should capitalize on the important progress it has made preparing and implementing reforms. This would reduce the size of the public sector and the level of trade protection and thereby further improve competitiveness and create a favorable climate for private investment. Priority should therefore be given to concluding the tax reform, liquidating the Complementary Pension Fund for civil servants approved last February, revamping the system of public procurement, and strengthening the regulatory framework for privatization.

Another major challenge to be faced is the modernization of the banking system. This should permit the introduction of new financial instruments and the provision of services required by the shipping and trading sectors of the economy in the more open environment. The revision of banking legislation, strengthening of banking supervision, rationalization of state-owned banks, and modernization of stock exchange and the insurance regulations envisaged under the program, are all especially significant for maintaining growth momentum.

These additional reforms are consistent with the objective of more fully integrating the reverting areas, i.e., maritime services, industrial processing zones and tourism. In light of Panama's access to the WTO, they should allow

the economy to more fully reap the benefits of globalized product and financial markets.

Finally, the case of Panama demonstrates the importance of maintaining a prudent macroeconomic policy mix, an outward market orientation, and the fiscal discipline necessary to control inflation. While positive real interest rates and more secure property rights are essential to avoid capital flight and create a more favorable environment for sustainable growth, renewed efforts should also be made to avoid burdening the most vulnerable sectors of the population with the cost of economic restructuring. This can be done by improving the quality of public expenditure to accommodate a well-targeted social safety net.

I therefore support the proposed decision and wish the Panamanian authorities success in their endeavors.

Mr. Lucenti made the following statement:

Given the Panamanian economic performance during 1996 and the fact that the authorities remain committed to their medium-term strategy of macroeconomic stabilization and structural reforms, we support the staff's proposed decision and grant the waiver for the non observance of the limits on the total net borrowing and domestic borrowing of the public sector.

In general, we agree with the staff's appraisal but we would like to comment on two aspects of the report. The first is related to macroeconomic performance, and the second to debt management .

We may say that during 1996 the macroeconomic performance of Panama under the program continued to be favorable. Real GDP grew at a rate of 2 percent, inflation remained low, the current account balance improved , the fiscal surplus increased, and the authorities took important steps in preparing and implementing structural reforms.

However, in the tables presented in the staff report there are signs which should draw the authorities' attention. The analysis of the behavior of some macroeconomic variables during the period 1988–96 shows that during 1996 the real GDP rate of growth and the real GDP per capita were the lowest since 1992; the inflation rate, measured as the percentage change in the consumer price index, was the highest since 1988; and the unemployment rate rose to almost 14 percent, which is a very high rate.

This situation calls for the acceleration of structural reforms in order to yield positive results in terms of stronger economic growth, reduction in unemployment and improvement in the situation of low-income groups. In this regard we welcome the authorities' intention to step up public investment and to increase the private sector participation in the economic activity through the privatization of public enterprises and further trade reforms.

On debt management, we commend the Panamanian authorities for the conclusion of the debt rescheduling process on which our Mexican and

Venezuelan authorities participated. This will give the economy a needed financial flexibility and will create a more positive environment to develop external and domestic private sector activities in support of the ongoing process of generating a more competitive economy.

Finally, we wish the Panamanian authorities every success in their efforts to build a solid and competitive economy and we support the proposed decision.

The staff representative from the Western Hemisphere Department noted that the authorities were taking a two-pronged approach to the tax revenue problems. In the short run, they were dealing with tax loopholes in the income tax system, particularly with the possible misuse of deductions for reforestation and tourism activities. Also, they were attempting to update the property tax base, which would likely be completed over 1997. Both those efforts would likely yield revenues close to 1 percent of GDP on an annual basis. Over the longer run, the authorities would undertake a major tax reform that would seek to expand the base for both direct and indirect taxation.

The government intended to sell 49 percent of INTEL to a private investor, who would also manage the company, the staff representative continued. However, the government would award 2 percent of INTEL to the company's employees, effectively making the government a minority shareholder.

Mr. Kafka thanked the Board and the staff for their interest and work on Panama. The Panamanian economy had performed well, and it was expected to continue that positive performance.

The Executive Board took the following decision:

1 Panama has consulted with the Fund in accordance with paragraph 3(c)of the Stand-By Arrangement for Panama (EBS/95/174, Sup. 1) and paragraphs 32 and 15 of the letters dated November 7, 1995 and July 1, 1996, respectively, from the Minister of Planning and Economic Policy, the Minister of Finance and the Treasury, the General Manager of the National Bank of Panama and the Accountant General, in order to review progress in the implementation of Panama's economic program.

2. The Fund decides that the second review contemplated in paragraph 3(c) of the Stand-By Arrangement for Panama is completed, and that Panama may make purchases under the Stand-By Arrangement, notwithstanding the nonobservance of the performance criteria on the limits on net borrowing and domestic borrowing by the public sector as of December 31, 1996 specified in paragraphs 3(a)(i) and 3(a)(ii) of the arrangement. (EBS/97/31, 3/6/97; and Cor. 1, 3/20/97)

Decision No. 11460-(97/26), adopted
March 21, 1997

3. GUINEA-BISSAU—1996 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY—SECOND ANNUAL ARRANGEMENT—REVIEW, AND WAIVER OF PERFORMANCE CRITERION

The Executive Directors considered the staff report for the 1996 Article IV consultation with Guinea-Bissau and the midterm review under the second annual arrangement for Guinea-Bissau under the Enhanced Structural Adjustment Facility (ESAF), together with Guinea-Bissau's request for a waiver of performance criteria (EBS/97/26, 2/20/97). They also had before them a statistical annex (SM/97/52, 2/20/97).

Mr. Yao made the following statement:

Under the second ESAF annual arrangement, the Guinea-Bissau's authorities maintained the thrust of their adjustment efforts, and achieved significant progress in key areas. Budgetary procedures were improved and important structural reforms were introduced, especially as regards the civil service and the public enterprise sector. Reflecting these efforts and an increase in agricultural production, the overall economic performance improved. Real output increased robustly and the external current account position, as a ratio to GDP, (excluding transfers) strengthened. The quantitative and structural performance criteria and benchmarks for the period under review were observed, thereby keeping the program on track.

Concurrent to the implementation of the ESAF program, the authorities also took the decision to join the West African and Monetary Union (WAMU). This decision is expected to bring important benefits in terms of monetary and exchange stability as well as creating a more favorable environment for attracting investments, among others. The Treaty providing for the entry of Guinea-Bissau into the WAMU was signed by the Heads of State of the member countries on February 20, 1997, and the Treaty for entry into WAEMU was signed on March 5, 1997. These treaties are being submitted for ratification to the respective Parliaments. Moreover, the Council of Ministers of Guinea-Bissau has approved the Agreement relating to the transfer of the rights of issuing currencies to the BCEAO. It is also worth noting that the established rate of conversion of the peso into the CFA franc will maintain Guinea-Bissau's competitiveness and promote export growth as well as the diversification of the economy.

As envisaged under the program, the strengthening of the public finances was a major aim of the adjustment program. In this context, the authorities took steps to improve tax and customs administration, and treasury procedures have been computerized. Collection efforts, especially of tax arrears have been strengthened and procedures for customs exemptions have been made more transparent. On the expenditure side, wage policy remained prudent. However, as a result of the depreciation of the peso, expenditure on some items under goods and services slightly exceeded program targets. In addition, domestic arrears' reduction were higher than projected. Overall, despite broad structural improvements as regards public finances, the primary

balance registered a surplus of 3.5 percent of GDP, instead of 4.7 percent programmed.

In the monetary area, following the strong money supply growth, in the first half of the year, mainly related to credit for the larger than expected cashew crops, monetary policy was tightened in the second half through an increase of the reserve requirements and an increase in bank interest rates. Moreover, the repayment of crop credit in the last quarter also contributed to a decline in credit to the economy so that at end-December 1996, credit to the economy was in line with the program target. Net credit to the government was, however, slightly higher than programmed. The increase in liquidity in the first half of the year, together with the depreciation of the peso and the speculation associated with uncertainties regarding Guinea-Bissau's entry into the WAMU were the main causes for the increase in inflation in 1996. However, in the last quarter of 1996, there was a noticeable deceleration in inflationary pressures. The authorities expect inflationary pressures to abate further in 1997, as credit policies are tightened.

In the structural area, progress was made in the reform of the civil service, and in the restructuring of the public enterprise sector, as envisaged under the program. The civil service census has been completed and a number of position has been eliminated. The payroll has also been made more comprehensive with the inclusion of contractual employees. As regards public enterprises, the authorities are continuing with the program of divestiture, with the liquidation of the pharmaceutical company, the brewery and the pork and poultry processing company. Moreover, electricity tariffs have been increased and the government will continue to reduce its arrears in the electricity company. Overall, all the structural benchmarks for end-June 1996 were observed. The structural benchmarks for end-September 1996 were also observed, except for the one regarding the deployment of teachers that was met with some delays.

Regarding the external debt, Guinea-Bissau was able to renegotiate debt-service obligations with a number of regional lending institutions, obtain some debt cancellations from Paris Club members and a deferment of payments on debt obligations with non-Paris Club creditors. This better-than-programmed debt relief offset the shortfall in external assistance and enabled Guinea-Bissau to close the financing gap. However, some payments arrears to Paris Club members were incurred in the third quarter of 1996, but were settled in October, and the authorities are requesting a waiver for the nonobservance of the performance criterion on the nonaccumulation of arrears.

For 1997, the Guinea-Bissau authorities will continue their efforts to strengthen Budgetary and Treasury procedures. The 1997 Budget is consistent both with the ESAF objectives as well as the budgetary discipline required by the participation into the monetary Union. The reorganization and the computerization of Treasury procedures will help to monitor outlays more closely, and the authorities intend to start implementing soon the recommendation of the Fiscal Affairs Department technical assistance mission regarding the modernization of the tax system and the improvement of tax

administration, while also simplifying the tax system. The excise tax is also being rationalized with a view to making it consistent with the external tariff of the WAEMU. Steps have been taken to improve the control of the Ministry of Finance on all phases of expenditure, and a survey of all domestic arrears is under way. These reforms, together with the introduction of a generalized sales tax later in the year, are expected to result in an increase in the current primary surplus in 1997. This surplus will enable repayments of domestic arrears and a further reduction of net bank credit to the government, while meeting external debt obligations.

Monetary policy will remain prudent in 1997, and the expansion of credit to the economy in peso will be kept at a minimum and aim at meeting the needs to finance cashew crops. Collaboration with the BCEAO has been strengthened to prepare for the necessary changes in the banking legislation and regulations, as well as changes in foreign exchange regulations. Also in order to bring the levels of deposit and lending rates closer to those prevailing in WAMU countries, the authorities have started to reduce those rates in Guinea-Bissau.

The structural reform program will be vigorously pursued in 1997 with continued emphasis on the privatization of the public enterprise sector. In this context, preparatory work has already started for the sale of the ceramics company, the sale or liquidation of the airline company, the liquidation of the petrol and gas distribution companies, as well as the reform of the agricultural sector. As regards the Road Fund, the authorities are fully committed to take action quickly to restructure its management and to strengthen its resource mobilization capacity.

In conclusion, despite the improvement in economic performance, the external position remains fragile and vulnerable to exogenous shocks. The external debt burden remains very high and will constrain severely the authorities' adjustment efforts, unless supported by strong debt relief that includes meaningful stock of debt reduction. In this regard, an early decision to benefit from the HIPC Initiative would greatly enhance Guinea-Bissau's efforts to return to external viability.

Mr. Autheman made the following statement:

I welcome Guinea-Bissau's joining the CFA zone. In fact, Guinea-Bissau will reap substantial benefits from its participation in the West African Monetary Union, provided it implements a program aimed at converging its macroeconomic and structural fundamentals with those of other members of the Union. I am, however, disappointed by the incomplete treatment given by the staff report to the cost of entry of Guinea-Bissau in the WAMU.

Guinea-Bissau's participation in the WAMU should raise the prospects for price stability, growth and the credibility of its policies. Guinea-Bissau will join a monetary area that has a proven track record of monetary stability and which is currently enjoying sustained growth under Fund-supported

programs. A regional monetary policy may be an appropriate solution for a small country whose central bank policy failed to gain credibility despite repeated Fund programs.

The authorities have demonstrated under the current ESAF arrangement their commitment to accept macroeconomic discipline. They have broadly kept their program on track and have given impetus to the structural reform program; further policy measures have been implemented with a view to their participation in the CFA zone, including a tight monetary policy consistent with the agreed upon conversion rate; their budget for 1997 calls for a marked improvement in the current primary surplus to 5.4 percent of GDP; finally, they have avoided granting large wage increases to compensate for the slippage in prices in 1996.

This being said, further reforms are needed to secure Guinea-Bissau's convergence:

The staff rightly underscore the need to strengthen budgetary discipline in the context of the monetary union. So far, fiscal performance has not been very satisfactory: under the ESAF program, there have been sizable expenditure overruns, including unexpected repayments of domestic arrears. It is a matter of urgency to address weaknesses in budgetary management and to implement comprehensive reforms in the tax system in accordance with the terms of paragraphs 11 and 12 of the Letter of Intent. I look forward to the Fund's provision of timely technical assistance to the authorities;

There is an urgent necessity for further progress in the area of public enterprise reform. In this regard, the staff report may have eluded current difficulties in the transport and energy sectors.

More generally, participation in the monetary union should act as a strong incentive to achieve convergence in such areas as trade and tax regimes, external liberalization, including Guinea-Bissau's acceptance under the Article VIII obligations, and labor market reforms. I expect a comprehensive convergence package to be included in the next annual arrangement. It is puzzling and regrettable that IDA has excluded at this juncture supporting Guinea-Bissau's reform program for the period 1997–99 (cf. Appendix III). This requires further explanation.

Comparison of the economic indicators could suggest that Guinea-Bissau's main macroeconomic fundamentals are broadly in line with those of other member countries, but I found differences in the size of the fiscal and current account deficits which reflect Guinea-Bissau's high debt-service burden to be quite striking. Of course, sustained adjustment is needed "to move the economy toward the point where debt relief could help ensure external sustainability," and the staff's indication of a decision point under the HIPC initiative by mid-1998 makes sense. But further delays in providing exceptional assistance under the HIPC initiative would be detrimental and it is therefore essential that Guinea-Bissau successfully implement its current program. If there are similarities in the economic structure of Guinea-Bissau

and other WAMU countries, one could also point out the extreme concentration of exports—87 percent of exports come from cashew nuts—that may affect the country's ability to maintain the right exchange rate. As the staff report explains, the conversion rate seems appropriate but one should not exclude a trade-of-terms shock that may, in the current debt situation, be difficult to overcome by further internal adjustment.

The cost of entry is only partially addressed in the program. If donors' support to eliminate the negative position of Guinea-Bissau's central bank seems to be warranted, the issue of financing Guinea-Bissau's capital share in the BCEAO still remains unaddressed, even assuming deferred payments. The annual cost will surpass the capacity of the country to implement further fiscal adjustments. It would be unfortunate if the participation in the WAMU were to add a monetary debt to an unsustainable external debt. This is a regional issue (since the WAMU arrangement implies equal participation of member countries in the capital of BCEAO, irrespective of each country's weight in the union) which should be settled at the regional level, not through external assistance. I think that the cost of Guinea-Bissau's entry in the WAMU raises the issue of BCEAO's seignorage affectation policy. I regret that the staff did not address this issue at all and I cannot agree with the assumption that a "higher level of external assistance than presently envisaged" may be needed (page 55).

The staff representative from the African Department said that the staff had been informed that the Guinea-Bissau National Assembly had ratified on March 13, 1997 the agreement on accession to the West African Monetary Union (WAMU) and to the West African Economic Monetary Union (WAEMU). On the same day, the National Assembly had approved the law demonetizing the Guinea-Bissau peso. Also, the convention between Guinea-Bissau and the BCEAO and the transfer of the issuing function to the BCEAO had been approved by the Guinea-Bissau Council of Ministers on March 19, 1997 and would be signed in a few days.

Mr. Mori made the following statement:

We welcome the higher growth rate in Guinea-Bissau in 1996 and the progress achieved under the ESAF program. As pointed out in the staff's report, real GDP growth—estimated in 5.8 percent—and the current account position have been more favorable than programmed. Fiscal performance has been broadly satisfactory. The program is broadly on track.

Guinea-Bissau's economy, however, remains extremely vulnerable to exogenous shocks which seems to be the major cause of economic instabilities, as reflected in the fluctuations in real growth rates and, especially, in prices. In 1996, growth benefited from favorable weather conditions. Inflationary pressure resulted, among other factors, from the increase in international cereal prices. The peso exchange rate depreciation arisen by uncertainties related to Guinea-Bissau's entry into the WAMU also seemed to add to the price increases. Regarding inflation, I wonder whether the consumer price index is still the limited basket that includes only three categories of goods. We would appreciate the staff's comments.

Guinea-Bissau's entry into the WAMU may represent an important step in the objective of building a more diversified economic structure and, therefore, reducing her vulnerability. The promotion of regional trade and investment as a result of the economic integration with the WAMU countries could make it viable to widen the range of economic activities. For this and other benefits of the entry to be fully reaped, fiscal discipline and elimination of structural rigidities will have to be pursued.

Therefore, we encourage the authorities to continue in their determination to implement structural reforms as well as measures on budgetary policies and reforms in the areas of taxation and budgetary procedures. In this respect, the technical assistance provided by the Fund in the fiscal area is welcome. We expect that progress in the fiscal situation would allow the authorities to increase the share of public spending in social sectors. The strategy for poverty alleviation followed by the authorities is in the right direction.

Guinea-Bissau's external debt situation is—and will continue to be—extremely burdensome. The debt relief and rescheduling agreed so far with official creditors, as well as disbursements, allowed Guinea-Bissau to close the external financing gap in 1996 and are also expected to close it in 1997. However, over the medium term, significant external assistance will be required for Guinea-Bissau to achieve a sustainable external debt position. As suggested in the staff appraisal, the possibility of Guinea-Bissau reaching the decision point under the HIPC Initiative at the end of the third annual ESAF arrangement, may provide a meaningful incentive for the authorities to persevere in their adjustment efforts.

We support the proposed decision and agree with the staff's recommendation to approve the request for a waiver. We conclude commending the authorities for the progress achieved so far under the ESAF program and wishing them every success in their endeavors.

Ms. Srejber made the following statement:

I am in broad agreement with the staff's recommendations set out in the staff appraisal and I agree with Mr. Autheman in his preliminary statement that Guinea-Bissau will benefit from its participation in the West African Monetary Union (WAMU). I would guess that this joining of the WAMU might explain why the letter of intent is not signed by the Governor of the central bank, but only by the Minister of Finance, but maybe the staff could enlighten us on this.

Nevertheless, I have concerns regarding the Guinea-Bissau track record, which has been very mixed the last 10 years, including under the current program. The first annual arrangement under the ESAF quickly ran into difficulties because of stabilization program problems and the midterm review under the first annual ESAF arrangement was not completed.

After the slippages were corrected, the second annual arrangement was launched. The track record under the second annual arrangement is not overwhelmingly impressive either—including stabilization difficulties, expenditure overruns, and monetary expansion. Also, implementation of structural benchmarks were, in many cases, delayed or not fully accomplished. The staff wisely does not comment on the end-December structural benchmarks in the text. The current review was delayed for about six months, and consequently the performance criteria for end-September and end-December were not established. Now we are supposed to review performance without having clear performance criteria, only quantitative benchmarks.

In addition, when one looks at the quantitative benchmarks, there are many adjustments and explanations and one has to go back and forth in the staff report to get a good idea of the performance adjustors and explanations. This does not make it easy for the Board to get a picture of what is happening in the country.

I would also like to ask about the future commitments. If we look at Table 1 on pages 30–31, new, forward-looking commitments are missing; I would like the staff to clarify why, and if this has to do with the delay of the midterm review and if this led to a delay in the negotiation of the third annual arrangement. Normally, the third annual arrangement would have been negotiated before the end of 1996, and we would have had criteria for the first quarter of 1997. Also, after slippages or delays, we are looking for strengthened commitments and now, frankly, I do not know how we are going to measure performance.

I have also a question concerning one policy target which is mentioned for 1997—the inflation target for 1997 set at 10 percent. I have read that it goes well into the financial programming, but is it realistic in view of the fact that inflation was 65 percent in 1996?

In view of this half-hearted track record, the staff suggestion that Guinea-Bissau could reach the decision point under the HIPC Initiative already in 1998 would not be in line with the HIPC Initiative, which implies as a first stage, three years of strong and sustained performance under an ESAF program. It is true that countries could receive credit toward a decision point for programs that are already under way, and countries that have interrupted their adjustment program during the first stage could also receive some credit for implementation of the program before it went off track, provided significant portions of the program have been sustained and the overall program has been brought firmly back on track.

I would like to caution the staff against raising expectations in countries by putting in the staff reports suggestions that clearly overstretch the criteria for the HIPC Initiative. Being among HIPC eligible countries does not mean automatic participation. The HIPC Initiative requires a strong and sustained policy track record.

Mr. Daco made the following statement:

Guinea-Bissau has made welcome progress under the second annual ESAF arrangement which should help it to deal with its still large internal and external imbalances and complete the structural adjustments aimed at opening the economy and broadening the export base in the medium term. Guinea-Bissau's debt sustainability analysis indicate that this will be a major undertaking requiring substantial external assistance, both financial and technical. The Fund will doubtless play a major role in this effort, provided that the authorities of Guinea-Bissau strongly deliver.

I agree with the staff that the program performance has been quite satisfactory but that the authorities still face many challenges. I can also associate myself with all the comments made by Mr. Autheman. In particular, I found that the staff report did not satisfy my thirst for information about Guinea-Bissau's entry into the West African Monetary Union (WAMU).

But before getting into this question, I have a more general comment about the executive summary. I think that the inclusion of executive summaries in the staff reports is worth the extra work it costs.

However, great care has to be taken to ensure that these summaries reflect the staff reports fully and accurately. From this standpoint, I could wish that Guinea-Bissau's executive summary were a little more candid. I know this was a midterm review whose Board discussion was postponed and therefore required the staff to make a second visit. But I was disappointed to find that the executive summary simply noted that all quantitative performance criteria for end-June 1996 were met, with no word about the quantitative benchmarks that were missed at the end of December 1996, nor the delays in structural benchmarks for end-September 1996 and end-December 1996. The summary could also have stated that although the 1996 fiscal performance was broadly satisfactory, the budget performance was somewhat weaker than programmed, with a current primary surplus of only 3.5 percent against 4.7 percent in the program (a sentence I quote from the report itself). This point about candor was also made by Ms. Srejber starting from another perspective.

Now let me make my European biased comment on Guinea-Bissau's entry into the WAMU. First, because Guinea-Bissau's economy represents only 1 percent of the zone and cannot threaten financial stability of the zone, convergence between Guinea-Bissau and the countries of the French franc zone is less important for entry into WAMU than is the case for countries entering EMU. Guinea-Bissau with its primary surplus has achieved some fiscal convergence with the existence of a primary budgetary surplus, but a less satisfactory convergence where inflation, interest rates and exchange rate stability are concerned. I therefore wonder if the authorities may not underestimate the dangers of over—or undervaluing their exchange rate at moment when Guinea-Bissau enters the zone. Could the staff comment on this issue?

My second question has to do with the conduct of monetary policy in the zone. I suppose that Guinea-Bissau's very high reserve requirement will have to be drastically lowered when Guinea-Bissau enters the union, and that the whole interest rate structure will also be adjusted downward. Unless they are restrained by prudential regulations, these circumstances could tempt the commercial banks to lend much more, causing excessively rapid money growth and reigniting inflation. How effective are indirect monetary instruments in the zone? Again, I would the staff to comment.

My third comment concerns Mr. Autheman's point about the costs to Guinea-Bissau of joining WAMU, which I found surprisingly high. If my calculations are correct, Guinea-Bissau will have to disburse about $130 million, equivalent to 50 percent of GDP or three years of exports, in order to join the WAMU. This includes the clearance of arrears, elimination of the central bank's present negative capital position, and Guinea-Bissau's subscriptions to capital shares in the BCEAO and the Western African Development Bank. About $40 million of this total will have to be paid in 1997. While I recognize, like the authorities and the staff, that Guinea-Bissau will derive many benefits from joining the CFA zone, including better financial and exchange rate stability and integration into the regional economy. In the long run these benefits will outweigh the costs. In addition, some of them, like cleaning up the central bank's balance sheet, would have to be paid anyway. But I cannot resist the temptation to ask how Guinea-Bissau can pay such huge amounts to join WAMU. I do not think the financing gap calculated for the coming years has taken account of such disbursements, and I would like the staff to comment on this issue as well.

Mr. Yoshimura made the following statement:

After the disappointing policy implementation under the first-year program, the authorities embarked upon a new program under the second-year ESAF arrangement in May 1996. It is welcome that the 1996 real economic growth rate and the external current account deficit are better than the program objectives.

However, this favorable economic performance reflects the large increase in cashew nuts production, which is the result of good weather conditions. Guinea-Bissau's economic structure remains vulnerable to external shocks. Needless to say, further efforts in both macroeconomic adjustment and structural reform are needed.

Let me comment on the results of the program implementation.

Although most of the performance criteria have been met, overall program implementation is far less than satisfactory.

On the monetary front, the benchmarks for the banking sector's net credit to the government and for net domestic assets were missed. Also, the inflation rate in 1996 far exceeds the program targets.

On the fiscal front, although I am pleased to note the prudent stance on wage policy, the target for primary surplus couldn't be met owing to the underperformance of revenue and expenditure overrun.

Furthermore, there are temporary external arrears, which is evidence of very weak external debt management.

On the structural front, while the staff says in the paper that "all the structural benchmarks for end-September 1996 were observed," some of the actions prescribed as end-December benchmarks have not been fully taken. Among these, the delay in the bidding on two state-owned enterprises is a matter of concern.

In view of this mixed performance, I have strong reservations about the completion of the mid-term review.

Nevertheless, assuming the authorities make substantial progress in policy implementation in the area of containing expenditure, improving tax and budgetary administration, and accelerating structural reform, including privatization, I reluctantly support the proposed decision to complete the mid-term review, and approve the waiver for nonobservance of a performance criterion. In this connection, I believe the staff should consider strengthening the third year program, including the adoption of more structural performance criteria.

As for the entry into the WAMU, I share the staff's view that the potential benefits of entering would exceed the potential cost. As the staff rightly pointed out, these beneficial effects will materialize only if the authorities make continued progress in strengthening financial policy and structural adjustment.

Finally, let me comment on the issue related to the HIPC initiative. Like a previous speaker I also have strong doubts that completion of the possible third-year ESAF program would automatically mean Guinea-Bissau had arrived at the decision point in light of the fact that the first year program have gone off track and that the performance of the second year is weak.

With these remarks, I wish the authorities well.

The staff representative from the African Department commented that the midterm review had not been delayed because of nonobservance of performance criteria on the part of the authorities, but because the authorities had accelerated their entry into WAMU and the staff and management had decided that it would be more appropriate to present the staff paper to the Board after the decision on the date of entry into the WAMU and the determination of the currency conversion rate. That delay had also allowed the staff to review performance as of end-December. The staff mission for the midterm review had concluded in September 1996 that the authorities had observed the end-June 1996 performance criteria. The staff had returned to Guinea-Bissau in December 1996 and, as the staff report indicated, there had been one slippage—the end-September and end-December benchmark for net credit to government had been exceeded by a relatively small amount. There had also been a small slippage in

December on the figure for claims of the banking system on the central government. As far as the structural benchmarks were concerned, the main slippage dealt with the nonissuance of tenders for the government's public sector divestiture program, but all other structural benchmarks had been met. The nonissuance of tenders for the Cerâmica de Bafatá and the delay in the liquidation of the TAGB airline company were being reviewed by the World Bank, but the authorities were aware of the need to accelerate such reforms; in fact, the Guinea-Bissau Council of Ministers had decided in early March 1997 to move forward with the liquidation of TAGB. The delay associated with the introduction of the compilation of the new consumer price index was due to the illness of the consultant providing that technical assistance; the United Nations Development Program was providing the necessary assistance to complete that work in early 1997.

Ms. Srejber wondered whether delaying the midterm review had been the best way to keep the Board informed of developments in Guinea-Bissau. Moreover, the staff report did not seem fully up to date; for example, information on the progress of civil service retrenchment did not go beyond end-September, and further information on the progress of negotiations with non-Paris Club creditors was lacking. As a result, compliance with the end-December structural benchmarks was not clear: three had been met, four had been delayed, and there was insufficient information regarding another.

The staff representative from the African Department said that the staff had recently been informed that the number of civil servants had decreased by 1,500 between end-1995 and end-1996—more than had been envisaged under the program. As was indicated in the staff report, the negotiations with non-Paris Club creditors—in particular the Russian Federation—had not been completed as of end-December, and the staff expected those negotiations to take some time.

The achievement of a mid-1998 decision point under the HIPC Initiative would be assessed on the basis of a number of elements, including performance from 1996 to mid-1998, the staff representative continued. While that decision was currently premature, strong performance in 1997 and 1998 could not be excluded.

The data on the quantitative benchmarks for September and December, while not highlighted in the executive summary, were included in the staff report, the staff representative pointed out. The authorities' slippage on the benchmark for end-December credit to the government would be reviewed by the next staff mission; that slippage had been due mainly to increased payments for domestic arrears and capital expenditure. The staff had encouraged the authorities to clear its domestic arrears as soon as possible and efforts made in 1996 to that end represented a positive development.

With respect to convergence with other WAMU members, the staff had analyzed exchange rate developments over the past 10 years relative to a number of indicators, including the consumer price index, unit labor costs, and the profitability of the export sector, and had concluded that Guinea-Bissau was not entering WAMU with an overvalued exchange rate, the staff representative remarked. The high inflation in recent years had been more than offset by the movement of the nominal exchange rate.

The imposition of reserve requirements associated with WAMU membership did not pose any major problem to Guinea-Bissau, because it had a reserve requirement higher than the more modest requirement of the BCEAO, the staff representative said. Commercial banks,

however, would be seriously constrained by prudential regulations, and they would have some liquid assets at the central bank that could be invested in the regional money market. The banks were not in a position to extend additional credit because there were relatively few creditworthy borrowers in Bissau. The banking commission of the BCEAO had already conducted an initial review of the two commercial banks in Bissau, and the formal audit would be carried out later in 1997. The staff expected that the banks would be asked to recapitalize and make further provisions for some nonperforming loans. The central bank had agreed with the two commercial banks on an indicative ceiling for credit expansion up to June 1997, and the staff mission would discuss with the central bank appropriate indicative limits for the remainder of the year. However, it was clear that any acceleration of credit expansion in Bissau would be currently inappropriate.

The staff report had not fully addressed the issue of the costs associated with WAMU entry because discussions between the Guinea-Bissau authorities and the other members of the zone and the BCEAO were ongoing, and there were some uncertainties surrounding the exact costs and the amount Guinea-Bissau could realistically pay, the staff representative explained. The staff had made a preliminary estimate of the cost amounting to much less than the $130 million figure indicated by Mr. Daco. There had been an understanding that the question of the payment of the one-seventh share of the BCEAO capital would be discussed during 1997, but that no payment would be expected in 1997. Also, in a spirit of solidarity and collaboration between the zone and Guinea-Bissau, it was understood that Guinea-Bissau would be asked to pay a reasonably affordable amount. However, there were still a number of uncertainties surrounding the cost of entry, including the exact amount of the BCEAO's capital and the extent to which the future dividends payable to Guinea-Bissau from the BCEAO would offset Guinea-Bissau's annual membership payments. The matter would be resolved by a meeting of the ministers of the zone in the coming months.

On the road fund, some measures had been taken recently by the authorities, including an increase in the car fees, the staff representative indicated. The World Bank considered that an overhaul of the road fund's management was needed soon in order to avoid an interruption in the Bank's transport project.

The staff had had extensive discussions with the authorities regarding the energy sector, and some measures had been taken at the end of 1996, including a 20 percent increase in the tariff structure, a significant recovery of existing arrears, and some transfers from the budget to cover certain capital costs, the staff representative said. It was important to recall that the electricity company was under private management—not a common feature in western Africa. The government did own the infrastructure, but discussions with the World Bank aimed at full privatization. The authorities seemed prepared to take additional measures, especially to avoid the interruption of the Bank's energy project.

The liquidation of the state-owned petroleum company was proceeding and would be completed with the sale of some storage tanks in the main harbor in 1997, the staff representative noted.

It was important to recall that the privatization program in Guinea-Bissau had been extensive in recent years, the staff representative remarked. Since the beginning of the decade, 46 public enterprises had been involved in the privatization and liquidation program, as indicated in Table 17 in the statistical annex. Further progress should be evident in the future.

The appendix in the staff report outlining IDA support for the authorities' 1997–99 reform program might have been incomplete, the staff representative considered. If progress on existing projects was satisfactory, IDA would likely consider additional credits to support structural reforms.

Mr. Palei made the following statement:

Nineteen ninety six was another year of uneven performance for Guinea-Bissau. The outcomes for growth and the current account were better than envisaged under the program. At the same time, there was an obvious lack of discipline in the monetary area.

I agree with the staff that Guinea-Bissau's entry into the West African Monetary Union and, later, into the economic union is a positive step for the country. Hopefully, this membership will contribute to macroeconomic stability that the authorities themselves failed to deliver. The common currency zone will force the authorities to cooperate with the other members of the union in deepening structural changes, especially in improving tax administration, restructuring of the banking sector, and reforming the foreign trade sector.

Since my opinion about the potential performance of Guinea-Bissau under the current ESAF program is unavoidably influenced by the prospects of this country entering the union, I join Mr. Autheman and Mr. Daco in their concerns about the financing of Guinea-Bissau's participation in the union.

From my point of view, the very admittance of Guinea-Bissau with its current indebtedness to the WAMU is a rather bold step for the BCEAO. I wish the staff's paper had more information on the conditionality of acceptance and the sequence of steps that lead to admittance into the monetary and, further, into the economic union. What are the risks, if any, that Guinea-Bissau will not join the group?

I welcome the authorities' attention to the problem of the external debt to bilateral non-Paris Club creditors. This debt constitutes a significant share of Guinea-Bissau's total debt. I hope that sooner rather than later more agreements will follow the ones signed in 1996 with Algeria, Cuba, Kuwait, and Saudi Arabia.

We know that Guinea-Bissau's existing debt burden is unbearable. However, the authorities need to realize that the debt relief through the HIPC initiative may only be the result of irreversible structural reforms, and not a precondition for them. The decision point by the middle of 1998 would make sense if there is sufficient evidence that the economy of the country is on track to an exit state. I think that in this respect Ms. Schreiber's comments on mixed performance of Guinea-Bissau are well placed.

Since the exports of goods and services play a key role in our debt sustainability analysis, I would ask the staff to elaborate on the concentration of exports. What services are currently exported and what are the opportunities for growth in noncashew nut exports from Guinea-Bissau?

When reading the staff's paper, I had mixed feelings about privatization in Guinea-Bissau. The list of the entities subject to privatization or liquidation looks impressive. But the revenue from privatization is negligible and consistently falls short of the program's targets. I would appreciate the staff's comments on this issue.

With these remarks I support the proposed decision.

I wish the authorities success in the face of the challenges ahead.

Mr. Schneider made the following statement:

Although Guinea-Bissau's adjustment effort spans the last decade, we have heretofore found the authorities' record on policy performance to be uneven and uninspiring—lacking the urgency and commitment that one would expect from a country faced with high inflation, severe external imbalances and high levels of external debt. We note, however, that the authorities have made some progress on a number of policy issues during the past year. These include: continued wage restraint, progress on trimming the civil service, and improvements in budgetary procedures and treasury and debt management; and forward movement in the government's divestiture program

We hope that this signals a new determination on the part of authorities to address the economy's serious deficiencies and put Guinea-Bissau on a more established path of reform. In this context, we are in favor of completion of the midterm review. Continued progress in a number of areas is still warranted, however. External imbalances, while improving, remain large and future performance—as Mr. Autheman points out in his preliminary statement—is heavily dependent on international prices for cashew nuts. Export diversification should be accelerated—building on the gains in nontraditional exports seen in the past year. We would be interested to hear from the staff in greater detail about ongoing efforts to further diversify exports.

The staff has also appropriately highlighted the need for further progress on improving public finances through greater control over expenditure and comprehensive tax reform. Entry into the WAMU only increases the need to enhance discipline over expenditures. We welcome the efforts authorities are making in this area, but concur with the staff that continued diligence is needed. With regard to revenue, the authorities' proposed tax reform program, as embodied in the Budget Law, is ambitious, but clearly necessary if efforts to increase public sector savings and diversify the revenue base are to be realized. Speedy implementation of the proposed consolidation of customs duties, simplification of the tariff structure, and reduction of the maximum tariff rate would also be welcome in the context of joining the WAEMU.

Further progress in state enterprise reform is needed to spur foreign investment. Remaining technical work on the ceramics enterprise and the airline, for example, should be completed and their sale or liquidation proceed

without delay. As noted in the staff report, it is also important that authorities extend state enterprise restructuring to the transportation sector. It has recently come to my attention that Prime Minister Da Costa very recently decided to dissolve the Guinea-Bissau's privatization council due to widespread council corruption, and that the government will reevaluate all privatization projects undertaken by the current council. I would appreciate the staff's assessment of how this is likely to affect Guinea-Bissau's privatization program—and more specifically—privatization of the national airline, the ceramics company, and the electric/water company.

We thank the staff for their analysis of the impact of Guinea-Bissau's proposed accession to the West Africa Monetary Union (WAMU). The staff's analysis suggests considerable benefits to be had from joining this institution. Guinea-Bissau's poor record on monetary policy, and the resulting periodic bouts of high inflation, points to the potential gains that an exchange rate anchor could offer for price stability. Further, the prospects for financial deepening and more rigorous banking system supervision certainly add to the attractiveness of the WAMU. However, we agree with Mr. Autheman that the medium-term financial costs associated with WAMU membership are a concern. This is particularly the case if, as the staff suggests, Guinea-Bissau's debt burden is not sufficiently reduced and, as the staff suggest, reliance on higher levels of external assistance than presently envisaged becomes necessary. We would welcome any additional information from the staff about how this fiscal burden is likely to be financed and over what time frame.

Clearly, Guinea-Bissau's large external debt burden (some 352 percent of GDP in 1996) is a constraint on economic growth prospects. Even debt-relief granted on the most generous terms by both Paris Club and non-Paris Club creditors will not be sufficient to establish a sustainable external position. We agree, therefore, that Guinea-Bissau is a potential candidate for HIPC debt relief. The staff have suggested that Guinea-Bissau could reach the decision point under the HIPC initiative—subject to establishment of a strong track record of adjustment—at the end of the third annual ESAF arrangement in mid-1998. It should be emphasized that access to the extraordinary level of debt relief provided under HIPC requires a similarly extraordinary level of commitment to reform by the authorities. Guinea-Bissau's policy performance during the past year has been broadly satisfactory, but not exemplary, and performance under the first year was mixed. This raises the need to flesh-out more fully the policy of what constitutes satisfactory performance to be counted toward the first three-year stage under the HIPC initiative. In any event, ample opportunity for further reform exists, as outlined in the staff report's recommendations, and we urge authorities to vigorously carry out the reforms necessary to meet the performance and structural benchmarks outlined in the program.

Mr. Esdar made the following statement:

At this stage of the discussion, I have only one point to make. Like Ms. Srejber and Mr. Yoshimura, I was puzzled that the staff seems to assume that the decision point under the HIPC Initiative could be reached in mid-1998. Obviously, the staff seems to be satisfied with the track record under the ESAF program so far. I have to admit I do not share this assessment.

As already mentioned, the first year of the arrangement could not be completed because of weak performance. The program under the second year of the arrangement had to be redesigned, and also under this second year there have been some deviations in the structural area and the inflation target could not be met. This, by the way, leads to the question of how it is possible that if a program is on track in its macroeconomic performance criteria, there is such a wide deviation of inflation. This raises a question of whether the program is appropriately designed.

Taking this all together, I would caution the staff not to raise wrong expectations in member countries with regard to the HIPC Initiative. I think we have agreed on a lot of flexibility within this initiative; however, there should be no flexibility at all with regard to the adjustment needs and with regard to the need to combine exceptional adjustment and exceptional additional debt relief.

In further program reports, I would expect that these adjustment requirements as a question of track record would be discussed in a more comprehensive and detailed manner. I had questions similar to Ms. Srejber's, which could be answered only in these discussions. I would expect that these things would be discussed very carefully in program reports.

Mr. Jones made the following statement:

I support the proposed decision.

The authorities have made a serious effort to strengthen their adjustment process. What is even more important is that they remain committed to the adjustment process. My overall assessment is that the authorities are moving in the right direction.

There have been a number of achievements due to the implementation of the program. Growth has been strong, and prospects are encouraging over the medium term. The government's divestiture program has worked well. The tax system is being reformed and tax administration improved. The authorities have also taken steps to control expenditures. It should be emphasized that prudent fiscal policies must remain a central tenet of the authorities' economic strategy, not only because it is necessary for macroeconomic stability, but also because of the need for the government to mobilize resources to be able to intensify its fight against poverty.

Looking ahead, we believe that the authorities need to remain vigilant in fighting inflation. We must remain mindful of the economy's vulnerability, given the narrow production base.

The external debt burden remains very high. I agree with Mr. Yao that the country needs strong debt relief, including meaningful stock of debt reduction in the context of the HIPC Initiative.

Mr. Himani made the following statement:

At this stage of the discussion, I can be very brief. Guinea-Bissau made some progress under Fund supported programs. Nevertheless, the external position remains precarious.

The authorities have elected to join the CFA franc zone. Membership in WAMU will likely yield substantial benefits for a country in Guinea-Bissau's situation. At the same time, by relinquishing monetary control to a regional central bank, the authorities are pursuing a strategy that could entail significantly higher risks. Reaping the benefits of membership in the zone requires the maintenance of strong discipline. Guinea-Bissau can ill afford slippages now, and any slippages after membership in the zone will likely only be magnified. Thus I fully concur with the emphasis by the staff, Mr. Autheman, and others on budgetary discipline.

Addressing the challenges posed by Guinea-Bissau's external position necessitate efforts by all. But, it is ultimately the country's own efforts, and strong track record, that are prerequisite for achieving a sustainable external debt position. The current ESAF program, if fully implemented, will go a long way toward this goal. Membership in WAMU may in fact allow for a better economic performance, that would otherwise be the case, but there should be no illusion that the road ahead has gotten any easier.

I support the proposed decision and, wish the authorities every success.

Mr. Santos said that he agreed with other speakers who had expressed concern regarding the staff's suggestion that Guinea-Bissau could reach the decision point under the HIPC Initiative at the end of the third annual ESAF arrangement in 1998. Such concern was important not only because of the policy slippages under the first ESAF program, but also in more general terms, because the Fund should try to ensure that there were no unreasonable expectations with respect to the HIPC Initiative.

The staff representative from the African Department noted that, with respect to the prospects for growth in noncashew exports, the staff considered that there were opportunities to improve tropical fruit exports. Such developments as recent foreign investment and the involvement of the IFC in new plantations should continue because the country had relatively rich soil and substantial amounts of water. Also, fish and shrimp exports and tourism could increase, but that would require further domestic and foreign investment. The country's entry into WAMU, and the associated prospect of further macroeconomic stability, might enhance investment opportunities.

While it was true that revenue from privatization had been negligible, it was important to recognize that privatized companies, such as the electricity company and the state petroleum company, were currently better run than previously, the staff representative remarked.

The manager of the privatization council had recently been dismissed and a replacement was being sought, the staff representative said. If that resulted in a reinvigoration of the privatization process, then it would be a step in the right direction.

The staff report had stated conditionally that the decision point under the HIPC Initiative could be reached in mid-1998, the staff representative noted. Clearly, the authorities' performance would need to be assessed carefully, especially to determine whether part of 1995 could be deemed as satisfactory or whether the whole year should be excluded from consideration.

Mr. Yao made the following concluding statement:

I would like to thank Directors for their comments and views on the adjustment effort of Guinea-Bissau, and the staff for its technical advice. Their recommendations and suggestions will be conveyed to my authorities.

Since the staff has provided answers to most of the questions raised by Directors, I would like to focus essentially a few points. The first is what are the benefits derived from Guinea-Bissau's participation in WAMU? I think it should be viewed from two sides. One, from Guinea-Bissau's point of view, and then from WAMU itself. As has been noted by previous speakers, the entry into CFA franc zone with its emphasis on prudent monetary policies should raise the prospect of price stability and credibility of its policies. It will also provide the authorities with a more conducive environment to strengthen the adjustment process and they expect to achieve more progress in the future.

There were also concerns about credit after Guinea-Bissau enters the zone. I can reassure Directors that within the WAMU zone, there is banking supervision that will control the credit of those banks and ensure that the inflation rate in Guinea-Bissau is in line with those of member countries.

What are the benefits derived by other WAMU countries and why did they accept Guinea-Bissau within their group? I think the first reason is regional solidarity. I can state that clearly that the cost itself has not been a major issue, because in my discussion with the WAMU authorities I was reminded about the high cost associated with Equatorial Guinea joining the BEAC zone. But today as we look at the potential of Equatorial Guinea, it seems like it was an appropriate decision. The other WAMU countries also are hopeful that as time goes on, Guinea-Bissau will become a prosperous economy and provide a market for goods produced within the region.

Regarding the costs, it was agreed that the burden would not be excessive for Guinea-Bissau to the extent that its adjustment effort would be undermined. This is the point that I think the Board should keep in mind.

Finally, I believe that fiscal policy remains a major issue. It is my understanding from the authorities that they intend to strengthen budget discipline, and that the technical assistance mission present in Guinea-Bissau has made some recommendations that will be implemented during the 1997 budget. The effort will be toward improving the tax and customs administrations and reducing the exemptions.

The Acting Chairman said that he took note of Directors' concerns about the track record of Guinea-Bissau. With respect to the inflation target and the problems associated with the price index, the inflation targeting approach of the WAMU would lead to the fairly restrictive policies outlined in the 1997 program and inflation would be targeted to fall to 10 percent.

In a recent meeting with the Governor of the BCEAO, the Acting Chairman stated, he had raised the question of the high cost of entry into the monetary union, particularly in the context of the already high external debt level of Guinea-Bissau. The response—as Mr. Yao had noted—was that there had been previous examples for which the entry costs had been considered excessive, but, in the end, entry had been positively concluded. In the past, foreign assistance had been tapped, and that was currently under consideration. The BCEAO was reviewing the matter, in particular, the issue of the future dividend payments that would flow to Guinea-Bissau. However, those costs needed to be considered in greater detail and would need to be incorporated into the next program.

The next staff mission would indicate clearly the view expressed by Directors that Guinea-Bissau's track record needed to be strengthened, the Acting Chairman concluded.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that, after a disappointing start, welcomed improvements had been made in implementing the second annual program under the ESAF arrangement. Economic growth had picked up and the current account deficit had improved. Nevertheless, Directors stressed that Guinea-Bissau's economy remained vulnerable to external shocks, and policy implementation should be strengthened to address internal and external imbalances, to diversify the economy, and to build the foundations for sustainable growth.

Directors welcomed the acceptance of Guinea-Bissau as a member of the West African Monetary Union (WAMU) and the West African Economic and Monetary Union (WAEMU). They noted that Guinea-Bissau's membership in those institutions should raise the prospects for growth, price stability, and the credibility of its policies. Directors emphasized, however, that for those beneficial effects to materialize, further progress was needed in strengthening public finances and accelerating structural reforms. It was noted that the cost of Guinea-Bissau's entry into the monetary union needed to be addressed.

Pointing to sizable expenditure overruns, including an unexpected repayment of domestic arrears, Directors stressed that public finances needed to be strengthened. That required comprehensive measures to reform the tax

system and tax administration and to strengthen budgetary management. On the revenue side, it was essential that the generalized sales tax under preparation be introduced rapidly, the customs tariff simplified—with rates lowered— and the tax and customs administrations further strengthened. On the expenditure side, it would be necessary to contain rigorously nonessential expenditures. Directors urged the authorities to make progress in civil service reform, with a view to streamlining the civil service. They also called for further improvements in budgetary procedures, treasury management, and expenditure controls.

In the area of public enterprise reform, Directors called for further progress in the privatization process, in particular, strengthening the financial position of the energy company, completing the liquidation of the airline company, and restructuring the Road Fund.

Directors considered that participation in the economic and monetary union should provide impetus for further external liberalization, including Guinea-Bissau's acceptance of the obligations under Article VIII, reform of the banking system, harmonization of trade and tax regimes with other union members, and labor market reforms. It was suggested that a comprehensive package of convergence measures be included in the next annual arrangement.

In view of Guinea-Bissau's very heavy external debt burden, Directors stressed that a strong and sustained track record in policy implementation was needed to reach a decision point under the HIPC debt initiative. A number of Directors expressed the view that setting a decision point in mid-1998 was premature, and therefore it was essential that Guinea-Bissau successfully implement its current program.

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

The Executive Board took the following decision:

1. Guinea-Bissau has consulted with the Fund in accordance with paragraph 2(d) of the second annual arrangement for Guinea-Bissau under the Enhanced Structural Adjustment Facility (EBS/96/79, Sup. 1, 6/4/96).

2. The letter of the Minister of Finance of Guinea-Bissau dated February 7, 1997 shall be attached to the second annual arrangement for Guinea-Bissau, and the letter dated April 30, 1996, together with its attached memorandum of economic and financial policies, shall be read as supplemented by the letter of February 7, 1997.

3. The Fund determines that the midterm review contemplated in paragraph 2(d) of the second annual arrangement for Guinea-Bissau has been

completed, and that Guinea-Bissau may request disbursement of the second loan specified under paragraph 1(b) of the arrangement, notwithstanding the nonobservance of paragraph 2(c)(v) of the arrangement. (EBS/97/26, 2/20/97)

Decision No. 11461-(97/26), adopted
March 21, 1997

4. KENYA—1996 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1996 Article IV consultation with Kenya (SM/97/70, 2/28/97). They also had before them a statistical appendix (SM/97/80, 3/7/97).

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

The following information has become available since the issuance of the staff report (SM/97/70, 2/28/97) for the 1996 Article IV consultation with Kenya:

Drought conditions are still afflicting many areas of the country. It is estimated that maize production in 1996/97 could fall short of domestic consumption by 10.4 million bags (or 30 percent of consumption). This shortfall could be met by drawing down stocks (3.3 million bags) and imports (7.1 million bags). The private sector and the donor community are expected to supply the bulk of this amount (4.1 million bags and 1 million bags, respectively), and the government has waived the value added and import taxes on maize to facilitate the needed imports. The remainder (2 million bags) will be imported by the government to provide famine relief to some 2.5 million persons.

The total cost of the famine relief program for the government is estimated at K Sh 5.2 billion, or 0.9 percent of GDP (K Sh 2.2 billion for maize imports, K Sh 2.0 billion for replenishing the maize strategic reserves, and K Sh 1.0 billion for transport and other administrative costs). The budgetary impact of the famine relief program in 1996/97 (July-June) is estimated at K Sh 1 billion (or 0.2 percent of GDP)—the remainder will be fully reflected in the 1997/98 budget. The authorities have informed the staff that the Cabinet has approved further cuts of recurrent and development expenditures to compensate for this additional spending in 1996/97; they intend to maintain the budget deficit (on a commitment basis and excluding grants) close to its target of K Sh 7.0 billion, or 1.2 percent of GDP.

The overall impact of the drought on the macroeconomic outlook for 1997 is expected to be significant. Agricultural production is now likely to be lower than previously estimated, as is manufacturing because of drought-related electricity shortages. Economic growth therefore is expected to be lower than envisaged in the staff report. The 12-month end-of-period inflation rate is estimated to have increased from 10.8 percent in December 1996 to 16.1 percent in March 1997, largely because food prices have risen by 15 percent over the period. Excluding food, however, the rate of inflation for

the same period has declined from 11.3 percent to 6.5 percent, reflecting, inter alia, the tight monetary policy stance of the authorities. Thus, on the assumption that weather conditions return to normal during the remainder of the year, overall inflation could remain near 10 percent for the year as a whole.

The impact of the drought on the balance of payments is expected to be largely offset by the more favorable international coffee prices than assumed in the staff report. Coffee exports are now expected to be some $130 million (or 50 percent) higher than earlier estimated, despite a drought induced decline in volume by 9 percent. The volume of tea exports has also been affected by the drought, resulting in a downward revision of tea exports by some $43 million. As a result, taking into account the additional imports of maize, the trade deficit in 1997 would be only some $40 million larger than projected, or 4 percent of the projected level of gross reserves at end-1997.

With regard to the privatization program, several of the measures discussed in the staff report (paragraph 26) have now been implemented. First, the government met the shareholders of the Kenya Petroleum Refineries on January 29, 1997 and began discussions on the broadening of shareholding in the refinery. Second, legislation to facilitate the divestiture of the Kenya Reinsurance Corporation has been approved by Cabinet, and, on February 26, privatization of four parastatals was completed and liquidation of another one approved. Third, the phasing out of the government's equity interest in the sugar refining sector is also proceeding, with Cabinet's approval of the divestiture of the Mumias Sugar Company and the preparations for the flotation of shares of the Chemelil Sugar Company on the Nairobi Stock Exchange. Fourth, the legislation to split the Kenya Posts and Telecommunications Corporation was submitted to Parliament on March 14. The actions that remain outstanding in this area are the initiation of the privatization of the new telecommunications company and the legislation on the restructuring of the energy sector. In addition, the actions relating to the benchmarks on the National Social Security Fund and the National Cereals and Produce Board are still outstanding, but are expected to be completed shortly.

Mrs. Guti made the following statement:

Kenya has come a long way with its reform effort and has made steady progress toward macroeconomic stabilization: inflation has been brought down to single digits; an overall budget deficit excluding grants of 1.4 percent of GDP for 1995/96 was one of the lowest in Sub-Saharan Africa, and indeed compares favorably with some industrial countries; a primary fiscal surplus excluding grants averaging 5 percent of GDP has been maintained for the last four years; a critical mass of structural reforms have been implemented; and market incentives have taken root. These reforms have enhanced the role of the private sector in the economy and improved the prospects for high growth.

Under the ESAF-supported program, approved in April 1996, the momentum of the reform effort has been maintained. All performance criteria and benchmarks for end-June and end-September have been met, except for the small external arrears. My authorities are taking all the necessary corrective

measures to meet the end-December 1996 benchmarks: Cabinet has approved the divestiture of government from the Kenyan Reinsurance Company and the sugar sector; an additional four public enterprises were privatized in February; government is broadening private sector participation in the petroleum sector; and legislation on splitting the telecommunications company has been submitted to Parliament and the necessary technical work for its privatization is proceeding. The authorities are moving speedily in the outstanding areas with a view to meeting all the requirements within the next few weeks.

On public enterprises, it is important to note that the combined operating profits of five key public enterprises increased from 0.8 percent of GDP to 1.3 percent of GDP in 1995/96. During 1996, Kenya privatized twenty-one public enterprises in spite of the technical problems encountered, involving mainly legal issues. Preparatory work for the privatization of a further twenty-two enterprises was also completed. The electricity tariffs were further adjusted upwards. The National Cereals and Produce Board, which has been a major drain on the budget, is being commercialized, and its past debts were partially settled. Future government involvement in grains will be limited to maintaining strategic stocks and ensuring food security. The privatization process is being expedited in 1997, and priority has been given to those enterprises with significant macroeconomic impact.

As administrative problems have largely been the cause of the small external payments arrears that were incurred, action has been taken to strengthen the administrative capacity in managing government and government-guaranteed debt. This should help avoid the incidence of external payments arrears in the future.

The 1996/97 budget seeks to limit the fiscal deficit to 1.2 percent of GDP and the execution of the budget during the first half of the fiscal year was broadly in line with the projections. The additional unexpected expenditures that were incurred were offset by savings on the wage bill and interest payments. The share of the wage bill relative to GDP will be reduced from 9.2 percent to 8.7 percent. In this connection, the size of the civil service was further reduced by 13,000. An additional 8,000 civil servants will be retrenched during the remainder of the current fiscal year. Also, a pilot project to verify the number of civil servants on the payroll is under way and has already identified 2,238 "ghost" workers in four ministries and these are being eliminated from the payroll. Eight ministries will undergo major restructuring with a view to strengthening their capacity, improving budgetary procedures and rationalizing staffing levels. Expenditure control is being strengthened, with the reinstatement of internal audits in each ministry and the strengthening of the Accountant General's office. The burden of taxation has been reduced; the maximum rates for value added tax and import duties were eliminated and compensated for by the broadening of the tax base and improvements in tax administration. Fund technical assistance on expenditure control has been sought and a resident advisor on tax administration is already in the field. Capital expenditure will be increased in line with recommendations of the World Bank public expenditure review in order to reduce infrastructural

bottlenecks particularly in the telecommunications, energy and transport sectors.

The authorities are confident of meeting their fiscal target for the year as a whole and, in this regard, they stand ready to identify areas for cutting expenditure and raising revenue to compensate for any additional expenditures that might prove inescapable. They have already applied this strategy to meet the rising costs of the drought.

The authorities have taken decisive action in dealing with cases of misappropriation of public funds. For those that were uncovered during 1996, the culprits were dealt with severely, resulting in the dismissal and prosecution of senior officers of the customs administration, the Kenyan Port Authority and the Ministry of Health. The authorities are vigorously pursuing the outstanding cases. They intend to put the procurement function under an independent agency to ensure full transparency and accountability and action is being taken to ensure that the tendering process is done in line with international standards.

The authorities are monitoring monetary developments very closely, consistent with their determination to keep inflation in single digits. In this regard the necessary safeguards are being put in place to ensure that inflationary pressures in 1997 will remain subdued, despite the upward pressures on food prices arising from the drought and higher-than-expected international prices. Meanwhile, monetary policy management is being improved. Parliament has approved the revision of the Central Bank of Kenya (CBK) Act, granting more independence to the CBK.

Developments on the external sector have been very encouraging. Export growth has been robust, the current account deficit has been declining and the reserve position improved. Capital inflows have responded overwhelmingly to the reform process and my authorities have been encouraged by this trend. They are monitoring closely the magnitude and structure of capital inflows and will gear their interest and exchange rate policies toward mitigating any undesirable short-term fluctuations.

In the long run, my authorities are fully aware that implementing the remaining structural agenda and a further improvement in the credibility of their financial policies are the key to enhancing investor confidence, attract long-term direct investment and accelerate economic growth and reduce unemployment. For this reason, they are attaching the highest priority to completing the ESAF mid-term review as soon as possible. Fund's support at this juncture is critical to avoid major disruptions in the financial markets, mitigate the effects of the drought and help the authorities stay the course of economic reform while proceeding with the general elections scheduled for the end of the year. The authorities have undertaken a major transformation of the economy and deserve the continued support of the Fund to accomplish their goals.

Extending her remarks, Mrs. Guti said that the staff's statement showed clearly that the authorities were taking the corrective measures to make good the end-December benchmarks.

Mr. Newman made the following statement:

Let me begin by first commending the authorities for the sound macroeconomic policies they have been pursuing in recent years. These policies have boosted economic growth and have contributed to a decline in core inflation and a much stronger external position. This year's budget incorporates some very welcome changes, particularly a lowering of the top value-added tax and tariff rates. It is indeed refreshing to see an ESAF which both reduces fiscal deficits and cuts taxes and tariffs.

I have just a few comments on the macroeconomic situation. I was particularly struck by the high real interest rates that are persisting in the economy, despite the economy's relatively strong performance. This is due in part to the authorities' sterilization of capital inflows. This raises the question whether there is an alternative approach to monetary and exchange rate policy that might help promote growth somewhat better by reducing real rates. I would like to ask the staff for their views about the scope for greater exchange rate flexibility, both to deal both with capital inflows and in the event that investor sentiment deteriorates.

The staff made the point that high real interest rates are partly due to the aggressive behavior of some banks. It is my understanding that one of the largest banks, which is substantially government-owned is paying high deposit rates which may at times exceed its lending rates, and that this bank also has substantial nonperforming loans. We wonder if there might be some additional measures the authorities should be undertaking to deal with this bank.

We also have to take a look at Kenya's macroeconomic performance in a longer perspective. The staff's baseline projection for the medium-term growth is about 3.5 to 4.5 percent under current policies. Even if policies were significantly strengthened, growth would increase only to about 6 percent by 1999. However, the staff believes that growth below 7 percent would neither substantially reduce urban unemployment nor increase rural incomes. Clearly, additional measures are needed to boost growth, particularly on structural issues. The staff makes a strong case that the major restraints on growth are now structural. Delays in deregulating and privatizing the energy, transportation, and telecommunications sectors are proving to be important bottlenecks.

Moreover, if Kenya is going to maintain private investment at the level necessary to achieve sustained growth at much higher levels, it also needs to improve its investment climate considerably. This will require not only more spending on infrastructure, but, more importantly, structural reforms that will facilitate privatization of state enterprises so that private firms are not facing with unfair competition.

Achieving higher investment rates is also going to require attracting foreign investment and continued donor support. I was struck that the foreign direct investment in Kenya is relatively small, given the substantial economic potential of the economy. In this regard, I noted there was a survey last year, which was published in the Financial Times, in which businessmen ranked Kenya as the country with the third highest prevalence of corruption. This may go a long way to explaining why foreign investors have been reluctant to put their money into the economy.

Donors' concern about governance issues, including corruption, was one of the principal factors underlying the suspension of support in recent years. It is critical that the authorities take strong measures to both improve transparency and demonstrate that the misuse of public finances will not be tolerated. There are still too many cases where codes of conduct are not followed and where public officials who engage in corrupt practices go unpunished. If Kenya is going to succeed in its development efforts and achieve the higher growth rates it clearly needs and can attain, it is going to have to act in this important area more forcefully than it has done in the past.

It would be useful to hear from the staff how they see Fund relations with Kenya evolving over the near and medium term. To put the ESAF back on track, the authorities will need to implement remedial measures to achieve the structural criteria and benchmarks that were missed. Moreover, they will also need to address new financial irregularities which have arisen by, for example, rebidding the electricity contracts. However, over the longer term I think we need to take a second look at what the most appropriate relationship between the Fund and Kenya is, particularly in light of the staff's projections which suggest there is little or no future need for exception balance of payments assistance.

There is a strong case for continued Fund involvement to ensure that the economy continues to perform as promised, particularly with the run-up to the elections. The question is whether or not a regular ESAF is the most effective means of accomplishing this. I believe it was Ms. Srejber, who raised the issue of precautionary ESAFs as another possible instrument for Fund involvement in countries like Kenya, and I would welcome any staff comments on that.

Mr. Shields made the following statement:

I agree with the staff's assessment of the current economic situation in Kenya. It could be described as satisfactory progress on most fronts, but nevertheless disappointing in a small number of key areas such as privatization, reform of public enterprises, and control of public expenditure. These failures are the elements which are preventing Kenya from fulfilling its potential, and from achieving higher levels of investment and growth.

The paper is frank on the corruption issue which, at the moment, represents the major constraint to investment in Kenya. Kenya must get serious about anticorruption measures. There is nothing which would give investors

greater confidence in Kenya's economy than the prosecution, conviction, and punishment of those responsible for major incidents. However, there is some disturbing evidence in this election year that efforts in this direction may be weakening again. It's crucial that during these ESAF negotiations the staff continue to press the authorities to control this problem.

As the paper acknowledges, Kenya has made significant progress in recent years. The end-June and end-September macroeconomic targets under the ESAF have largely been met. Mrs. Guti has described the encouraging progress in restructuring some of the major public enterprises in the fiscal 1995–96 year. The authorities deserve congratulations on their fiscal management during that year. It also looks from the descriptions in the staff report as if exchange rate policy is becoming more consistent, with the possibility of improved management; this has been weak in the past.

Although there has been progress on the macroeconomic side, the overall fiscal data suggests that there has been some slippage in the current fiscal year. There are particular expenditure pressures. One major element is the need to combat the risk of famine in the north. There is, however, some additional foreign aid, including our own, coming in to help relieve the effects of the famine.

But if we're looking at whether fiscal management will stay strong, we do have to acknowledge concerns about the effects on public sector wages of the presidential committee.

Kenya ought to be a high achiever. The staff was right to emphasize in the report that it can and it should do better than it has. Kenya is not lacking in natural or human resources and it's not excessively indebted. These factors mean that it could attract much more foreign investment and higher domestic investment than it does. Only by doing that would it make any significant impact on poverty. But there is a need for significant structural reforms. It's also important that Kenya regularizes its debt servicing.

The main factors likely to inhibit growth and investment over the near future include both external and internal factors, and in particular the effects of the drought. But I'd also like to mention the increasing gap in electricity generation, and the poor quality and effectiveness of key public expenditures. These issues raise doubts about the authorities' commitments to structural reforms, particularly in power and telecommunications and in their approach to privatization, although there have been some successes in that area.

More stress should also be placed on the impact of high real interest rates on investment in the election run-up.

I am pleased to note that comments from Mrs. Guti and in the papers that the Kenyan Authorities are giving the highest priority to securing completion of the midterm review of ESAF as soon as possible. In order to secure that completion, the staff must be satisfied with the pace and quality of

major structural reforms, as well as the thrust of fiscal policy toward lower taxation and better management of public expenditures.

Kenya is yet again at a critical juncture. The momentum of reform must be maintained. That's going to be more difficult in the near future, even though the pressures on the balance of payments at the moment are largely absent, and the foreign exchange reserves are fairly strong. But the Kenyan Authorities should not be under any illusion that they could continue to make progress without the ESAF. They need to get their policies back on track.

So I strongly encourage the Kenyan government to go the extra mile to tackle the issues which are currently preventing completion of the review. I hope the staff will work to resume contacts, and agree to clear goals with the Kenyan Authorities for completion of the review, particularly on the issue of electricity contracts. It is also important that there is early presidential assent to the act of amending the Central Bank of Kenya Act.

Lastly, Mr. Newman raised the point about precautionary ESAFs. We have long been conscious of the fact that it would be nice to have more program instruments available. I, personally, do not quite see a realistic prospect for any new facilities, except perhaps for a precautionary ESAF.

Mr. Chelsky made the following statement:

I would like to thank the staff for a balanced and frank assessment of developments in Kenya over the past year. This chair broadly endorses the staff appraisal and many of the views expressed by Messrs. Newman and Shields, and will therefore make only a few supporting comments.

Economic performance over the year was mixed, with much on the macroeconomic front to be encouraged and much on the structural front to be improved, particularly if favorable macroeconomic developments are to be sustained.

The government's response to the drought appears reasonable assuming that weather conditions return to normal during the remainder of the year although we concur with the staff that there is scope for further reductions in unproductive and low-priority expenditure. In this regard, I would be interested in hearing from the staff or Mrs. Guti about what contingency measures are being considered by the authorities to minimize the medium-term impact on the economy and protect spending on health and education should weather conditions not improve. We would also note the importance of protecting and enhancing the quality of national accounts and related sectoral data and would therefore caution against sustained cuts in this area.

Clearly, the predominant challenge facing the Kenyan authorities in the coming period is, as the staff have noted, to "establish the credibility of the government's commitment to economic reform." A major test of this commitment will be with respect to privatization efforts in energy and telecommunications given the critical importance to broad private-sector

development of the infrastructure and services provided by these sectors. The importance of progress in these areas should not be understated when a decision is made on completion of the midterm review.

This chair is also concerned that, despite recent efforts to improve the situation, expenditure management continues to be problematic. We therefore welcome indications from the authorities that they will strengthen expenditure controls and adopt corrective measures promptly. The importance of strong and visible efforts to improve transparency and accountability in the public finances is essential, not only for its direct macroeconomic importance, but also as a means of building private-sector confidence in the government's commitment to sound financial management.

In this regard, we are pleased to note recent actions to address instances of corruption in a variety of areas and would encourage the authorities to build on these efforts to ensure that transgressions are consistently acted upon. This will require remedial action to address the recently-awarded power purchase contracts that were found to be flawed. We would also urge the authorities to consider efforts, if not already undertaken, to enhance the capacity of the judicial system to deal with charges of irregularities in a timely manner. This would make an important contribution to establishing a reputation for improved governance.

With respect to the concern raised by the staff with volatile capital flows, we fully support the strategy to allow for greater variation in the exchange rate as well as to avoid resort to short-term capital controls which would be inappropriate given Kenya's particular circumstances. We share the staff's concern with potential capital outflows arising from the pressures due to the current political calender. We concur with the subsequent need to remain vigilant on monetary policy but would argue that the authorities should be encouraged, as a first best solution, to resist pressure for fiscal easing and to take the required measures to enhance transparency and accountability as a means to strengthen investor confidence. At the same time, we concur fully with the staff's recommendation that foreign exchange market intervention should focus on maintaining orderly conditions in the market and not be a "primary response to a weakening in sentiment toward the shilling."

Finally, given the conditions under which the authorities have indicated they will eliminate the current multiple currency practice, we are prepared to support the proposed decision although we wonder if there is not scope for an earlier phasing out of this practice.

Mr. Leijdekker remarked that his chair had brought up the idea of a precautionary ESAF several times in the past—the first time during a discussion on Lesotho. Kenya might be a good candidate for such an instrument as well. During the course of the discussion on surveillance, several Directors had noted that a staff-monitored program was not sufficient to confer the seal of approval needed by many countries to attract donors. At the same time, GRA arrangements entailed costs, and it was clear that, if a balance of payments need ever arose in some of these countries, the arrangement would need to be converted from a GRA arrangement to an ESAF arrangement, as in fact had been presupposed in the case of Lesotho.

While the ESAF instrument did not allow for a precautionary arrangement, that possibility could be explored, perhaps at the time of the next evaluation of the ESAF.

Mr. Donecker, noting Kenya's persistent and sustained current account surpluses, wondered whether the country still qualified for further ESAF assistance. Was there a protracted balance of payments problem which was a precondition for ESAF assistance?

Mr. Al-Turki made the following statement:

I am encouraged by the gains in Kenya's macroeconomic balance since 1994. Last year, financial policies stayed on track, the current external deficit fell and inflation remained in the single digit level despite the effects of weather and other exogenous shocks. The authorities' determination to sustain these welcome trends is reassuring.

It is thus unfortunate that the ESAF-supported adjustment and reform effort is nonetheless at a crossroads. As Directors emphasized during last year's consultation discussion, an improved macroeconomic environment is only part of the requisite for the economy to grow at full potential. The challenge is to also have matching progress on the structural reform front where performance has so far been less than satisfactory. As the staff appraisal makes clear, the key priorities are to enhance investor confidence and to ease the institutional and infrastructural bottlenecks that now confront the economy. Thus, the authorities must both remain vigilant to preserve macroeconomic balance and step up implementation of the structural reform agenda.

The continued priority for fiscal consolidation is well-placed. In that connection, I welcome the authorities' strategy of basing budget improvements on containment of spending rather than on new revenues. I also fully share the staff's emphasis on greater prioritization of expenditures to enhance the quality of fiscal adjustments. I am thus encouraged by Mrs. Guti's helpful statement regarding the increase in capital spending to deal with infrastructural bottlenecks. I also agree in principle with the staff's advice for further fiscal consolidation. However, p. 10 of the staff report recognizes only a limited scope for additional adjustments in the short run. The staff comments will be welcome.

The authorities' determination to remain vigilant on the inflation front is reassuring. The present conjuncture, especially the upward pressure on prices in the aftermath of the drought, argues for a continuation of monetary restraint. A premature easing can have adverse implications for inflation and the exchange rate. In this context, I strongly endorse the staff's priority for enactment of the bill to strengthen the central bank's independence.

Speed up of the structural reform effort is an immediate priority. In particular, emphasis has to be on stepping up the privatization drive. I am therefore encouraged that early action is now anticipated on both privatization of several parastatals and legislation for early restructuring and privatization of the energy and telecommunication sectors. I also welcome the action envisaged for greater transparency and discipline in the management of public contracts.

Effective action in this regard will both boost business confidence and help preserve the improvements in macroeconomic balance. I hope progress in the structural reform front will merit an early conclusion of the midterm review under the current ESAF arrangement.

With these remarks, I wish the authorities success in the difficult tasks ahead.

Mr. Andersen made the following statement:

I would like to thank the staff for a candid and concise report on Kenya. I share the thrust of the staff appraisal, but would like to take up a few areas for emphasis concentrated on structural issues.

I find it fully appropriate that the staff has underscored that the Kenyan economy is at a critical juncture. I welcome that the macroeconomic stability was broadly preserved in 1996, and the important progress in some areas of structural reforms, including the civil service reform. However, Kenya has a reputation of being a patchy and somewhat hesitant adjuster, and the still slow progress in a few critical areas makes it somewhat difficult to deny such an impression. Structural efforts required to create an environment that would enhance investor confidence and lead to a realization of the country's large growth potential have fallen short of what is needed. I am here, in particular, referring to the delays in a number of important areas, such as legislation to allow active participation of the private sector in power generation, the privatization and liberalization of the telecommunications market, and the divestiture of so-called nonstrategic parastatals, and last but not least the continuance of financial irregularities and misuse of public funds. The staff also lists other developments that adversely affected the business environment in Kenya and which, accordingly, are reason for concern. Indeed, Kenya still has serious problems of confidence as illustrated also by the high interest rates.

This situation calls for a major effort of the authorities to accelerate the reform process and to strictly stick to the goals of the program under the current ESAF. I am concerned, in particular, that Kenya continues to misuse its large potential, and is mischanneling the scarce resources because of poor governance. Kenya needs to do a lot in order to create conditions facilitating high sustainable economic growth, including forceful actions to eliminate corruption and ensure transparency and strict discipline in the public sector. As emphasized on many occasions, including in the World Economic Outlook to be discussed shortly, the effectiveness of economic reform packages in delivering higher growth and long-run prosperity often depends on the quality of governance in an economy, and not only do weak governance and corruption tend to lower government tax revenue and thereby reduce the possibilities of critical public investment in areas such as health and education, including increased efforts targeting the poorest of the poor, but they also deter both domestic and foreign direct investments that are so important for realizing Kenya's huge growth potential. Also, the importance of a credible and efficient judicial system is important in that respect. While it is difficult to get a precise grip on the magnitude of the problem, a number of studies, including

the one referred to by Mr. Newman, support the impression of a relatively huge problem, not least in comparison with countries that might offer alternatives to Kenya for potential investors. In addition, there is some anecdotal evidence relating to foreign investors who have decided to abandon their investment plans in Kenya with extraordinary kickbacks demanded by powerful individuals often cited as reasons. I welcome the steps already taken to deal with the misappropriation of public funds, and the elimination already of more than 2,000 so-called "ghost workers" from the payroll in four ministries as referred to by Mrs. Guti in her statement, but more is clearly needed, and I join the staff in urging the authorities to take decisive actions in these areas in order to promote a more growth friendly environment.

Before concluding, I have just one more specific issue, which I would invite the staff to comment on.

I find it worrisome that the staff anticipates that the overall economic environment could become increasingly uncertain as the general elections approach. It raises some question with respect to the ownership of the program and on the public support of the reforms which the staff may want to comment on. In any case, to ensure that all Kenyans will have full opportunity to vote for their preferred candidate on an informed basis will give a strong and positive signal to investors and donors, and I urge the authorities to resist any possible pre-election pressures to allow slippages and to keep discipline in public finances.

Let me conclude by welcoming that the authorities, according to Mrs. Guti's statement, are attaching the highest priority to ensure that the remaining structural agenda is implemented and that the ESAF mid-term review is completed as soon as possible. Kenya needs to adhere to bold and sustainable stabilization and reform policies for many years to come in order to increase the living standards of the population and to provide new jobs for a rapidly growing labor force, and what is urgently needed at this critical juncture. is a breakthrough in the critical areas, including privatization, public enterprise reform, and discipline in public finances, bolstered by the promotion of good governance in all its aspects, and, of course, maintenance of macroeconomic stabilization policies. Like Mr. Newman, I would be interested if the staff could share their thoughts on future Fund relations with Kenya, including whether the idea of precautionary ESAF arrangements could have some relevance in the case of Kenya.

Mr. Autheman made the following statement:

This report raises several interesting policy issues. Since I am in broad agreement with colleagues on the staff assessment, I will focus on these policy issues.

The staff assessment is unusual; when we look at the record, Kenya's macroeconomic performance is quite good. Most of the performance criteria and benchmarks for structural actions have been satisfied, albeit with some

delay. We rely on the staff's judgment on the lack of sound management of public resources to delay the review.

Of course, I do not mind that, but this approach is quite outside our traditional approach in assessing whether the review can be completed or not.

Indeed, there are several policy issues. First, one rightly raised in my view by Mr. Newman is whether there is a balance of payments need in the case of Kenya. The current account is in balance. The overall balance registered significant surplus, and there is no risk in the present macroeconomic stance that this position cannot be sustained.

Therefore, the purpose of an ESAF arrangement is quite different from the reason why they have been initially designed, as recalled by Mr. Donecker. We use the ESAF because we know that donors want the seal of the Fund before continuing to channel high levels of aid and the only instrument we have is low-access ESAF arrangements.

But, since the purpose of Kenya at this juncture is not to restore macroeconomic balances, but to meet the conditions for better growth prospects, we have to rely on judgment and not on performance criteria in assessing the performance.

Therefore, I think it is right to ask whether other approaches would not be more relevant, be it a precautionary ESAF to be created, or even a precautionary stand-by. After all, there should be a cost to macroeconomic slippages which would deteriorate an external position which can normally be sustained. And the fact that Kenya would know that the support of the Fund would come from a stand-by could be a greater deterrent to incur slippages than the access to Fund concessional resources.

Another option would be to design a specific post-monitoring mechanism; some form of staff-monitored program with the proper publicity on which IDA and other donors could rely. These issues are not specific to Kenya. They come out of this occasion. And we know that in the coming years, more countries may present similar situations.

Related to that is the proper role of the Fund and of IDA. I do not mind the Fund postponing the completion of a review subject to governance or corruption matters. But, quite frankly, I do not think it is up to the Fund to review the award of power plant contracts. This would rather fall under the traditional purview of IDA. I do not think that the Fund should be directly involved in the monitoring of such issues. All the more, since there is presently a structural adjustment credit on parastatal reform, which is clearly the core of one of the issues raised by the staff report.

The staff report proposes two medium-term scenarios and it clearly shows that it is not enough to preserve the savings and investment balance to accelerate growth; basically, the rate of investments has to be increased. And the staff's argument that it does not expect the present policy to raise

investments justifies the recommendation not to conclude the review. But we are facing a difficulty. We cannot say that improvements on some outstanding corruption issue will be enough to raise investments. Indeed, we can find many countries with strong growth, a high level of corruption and a high level of investments. And, indeed, the better the growth prospects, the more corruption can prosper. And so it is not enough to settle these matters.

Another point which, in my view, is closer to our mandate is the lack of confidence of the private sector in government policies; the fear is that the 1992–93 slippages can be repeated at any time. This is related to the institutional framework within which macroeconomic policies are implemented. There is widespread room for discretion in Kenya and not many binding rules. In this regard, I find that the form of the Central Bank of Kenya, which has been endorsed by Parliament, is fundamental progress which deserves praise. Our recommendation to consider a more flexible exchange rate policy, which in the present situation I support, will further increase the room for discretion and reduce the rule-based environment for setting policies.

So I agree with Mr. Hino that the objective now is to strengthen investment prospects and to improve the investment climate. The difficulty is that we do not know very well how we can do it. And I think we need to give some thought to that issue. How can we best help ESAF-eligible countries which have successfully completed the basic adjustment which we require, have put fiscal policy on track and have restored external balance? How to help them improve growth prospects in a lasting way, which refers both to the credibility of the policy and the progress on structural reforms?

Clearly, IDA and bilateral donors are expecting the Fund to play that role. They are not expecting the Fund to step aside as long as the current account is in balance. I agree with Mr. Shields on that point. But we, therefore, need to work on our policy proposals. Usually, I do not like to ask for a staff policy paper, especially outside the work program discussion, but I think in our next work program we need to look at this matter.

Mr. Shields remarked that the business community cited lack of policy consistency, corruption, and lack of progress on structural matters as impediments to increased investment. While addressing those concerns might not fully resolve the investment issue, it would likely be viewed as a step in the right direction. It would also legitimize the staff's insistence that the authorities should keep to their commitments in some of the structural areas. Without it, confidence would not likely improve and, therefore, the ultimate goals of the ESAF program would not be met.

Mr. Autheman said that the staff was correct in pointing to all of the issues mentioned by Mr. Shields. However, the Fund should be careful not to assume that the answer to the low investment problem was simple. Moreover, by emphasizing specific corruption issues the Fund might weaken the focus on the fact that the weakness of the views that framed the policies had led to the recurrence of the problems.

Mrs. Guti emphasized that the failure to complete the review, more than anything else, would damage the financial community's confidence by creating a perception that the reform

program was not going well. The authorities were taking all the necessary corrective measures to meet the benchmarks and to correct the financial irregularities.

Mr. Donecker stated that the concerns of the investment community should not be overlooked. It was natural to ask why Kenya's performance and investment was not as strong as it could be. After all, Kenya was in a particular advantageous position compared with most of its African neighbors. It was blessed with an abundance of natural resources; it had a favorable geographic position; it was large enough and its economy broad-based enough to stand on its own feet; it had benefited from several Fund arrangements. The staff had rightly pointed to some of the areas that needed to be urgently addressed by the authorities. The Fund should encourage the authorities to take the necessary action to overcome the obstacles identified by the staff and the investment community.

Mr. Daïri suggested that the Fund should be more moderate in its judgment of Kenya, given that the country's performance had been relatively good, as reflected in economic growth, inflation, external position, and the progress in structural reforms.

Mr. Andersen noted that both the staff and all speakers had commended the authorities for their macroeconomic and structural policy achievements. While it was true that the Fund should not micromanage all policy areas, it was appropriate for the Fund to point to issues of significant impact on macroeconomic developments. In that context, sufficient evidence existed to suggest that the emphasis on corruption was warranted.

Mr. Kannan made the following statement:

> We welcome the improvements in the external current account balance and central government overall balance position. However, the growth is yet to pick up and inflation control remains as a major challenge to the policy makers. Notwithstanding progress in macroeconomic management, a sustainable higher growth path is not clear at this stage. Furthermore, macroeconomic stability would remain vulnerable unless strong actions are taken to establish the credibility of the government's commitment to economic reform. In this context, the five objectives of the ESAF program, as outlined in para 6 of page 6 are still valid and we encourage the authorities to continue the reform efforts in achieving them.
>
> As explained by Mrs. Guti in her useful statement, we are encouraged to note that all performance criteria and benchmarks for end-June and end-September have been met, except for the small external arrears.
>
> We welcome the commitment of the authorities to keep fiscal deficit target of 1.2 percent of GDP in 1996/97 after taking into account the cost of famine. We encourage the authorities to eliminate completely "ghost" workers and carry out the civil service reform as early as possible. Furthermore, the reduction in wage share is a welcome development that must be continued. In order to sustain the low fiscal deficit, the importance of adequate expenditure control is to be duly recognized. In this respect we draw the attention of the authorities to the five areas as mentioned in page 9, para 16.

In the monetary area, while we agree that the key objective of the monetary policy would continue to ensure low inflation, easing of interest rates in the first half of 1997 might not jeopardize the achievement of the inflation target. This action, to some extent, would also address volatile short term capital inflows. In the field of monetary policy management, we welcome the revision of Central Bank of Kenya Act and the approval of granting more independence to the CBK. Bank supervision is to be strengthened and every attempt should be made to reduce nonperforming assets.

The staff have rightly drawn attention to the persistent recurrence of financial irregularities and we are encouraged to note the steps initiated by the authorities, as explained in Mrs. Guti's statement. Continuous and rigorous monitoring of these steps are needed so that adequate credibility is in place which alone would pave the way toward macroeconomic stability.

We fully share the debt sustainability analysis of the staff. If the authorities continue to pursue prudent financial and debt policies, Kenya should be able to meet its debt-service obligations without having to request itself or rescheduling on debt owed to official creditors.

With this, we wish the authorities every success in their endeavors.

Mr. Donecker made the following statement:

We support the staff's appraisal and the general thrust of the staff's recommendations. This certainly includes also the positive comments of the staff on the macro-economic management of the Kenyan authorities. We are grateful to the staff for a frank and clear assessment of Kenya's economic situation and policies as a good basis for our discussion today. This is all part of our enhanced surveillance, as recommended by the Interim Committee.

However, as the staff and others have pointed out, the Kenyan economy is at a critical juncture, and we hope our advice will be helpful. It certainly is meant to be constructive. Kenya's remarkable adjustment progress over the last two decades is one of the Fund's success stories and we sincerely hope that it continues to be so.

As I have explained before, Kenya is in a particularly advantageous position compared to many African neighbors.

Against this background of great growth potential we concur with the staff that it is very regrettable that the authorities have not made more timely, better use of the additional Fund assistance under the current ESAF program.

In view of the delays and slippages in the implementation of the agreed comprehensive structural reforms as well as the extent of bad governance noticed by the staff, and commented upon by other speakers, the Fund can ill afford to continue to provide preferential financial assistance under the ESAF to this member unless there is much greater willingness to implement rapidly the delayed structural measures, to substantially improve governance and to

cooperate fully with the Fund. The discovery of 2238 "ghost" workers in four ministries as a first result of a pilot project to verify the number of civil servants on the payroll, as quoted by Mrs. Guti in her buff, is indicative of the urgent need to strengthen expenditure control in and the efficiency of public administration.

We encourage the staff to follow economic policies in Kenya very closely and to insist on sufficient progress with the implementation of the agreed comprehensive structural reform measures before proposing the conclusion of the mid-term review of the current first annual ESAF arrangement.

We concur with the staff that decisive action in the management of public resources, in particular tight control of expenditures, is also needed for the advancement of the objectives of the ESAF supported program over the medium term.

As to monetary and exchange rate policies in the immediate future, we believe a restrictive stance of monetary policy as well as sufficient exchange rate flexibility to preserve the external competitiveness are clearly advisable in view of inflationary pressures that are only partly resulting from the recent drought. We welcome the greater independence for the Central Bank of Kenya

In conclusion let me make it clear that we are very supportive of, forceful actions of the Kenyan authorities to implement the agreed structural reforms.

Kenya has indeed great economic potential. The challenge is to unleash economic forces in the right direction by establishing the proper framework for substantial and sustainable high quality growth. I hope the authorities will show the wisdom and strength to implement prudent financial policies and comprehensive structural reforms and will act resolutely against corruption. We genuinely wish them much success.

Mr. Tahara made the following statement:

I would like to join the previous speakers in commending Kenya's recent overall macroeconomic performance. At the same time, however, I would like to express concern about the delay of structural reform and the occurrence of financial irregularity. This seriously undermines the credibility of the authorities' commitment to strong economic adjustment and structural reform. Last year when the ESAF arrangement was approved by the Board, most Directors stressed the importance of improving financial management and structural reform. I am disappointed to see that our message to the authorities has not been taken seriously.

In order to regain the confidence of the international community, the authorities must make renewed efforts to correct these irregularities fully and immediately, taking necessary preventive measures to ensure they do not happen again. With regard to structural policy, the authorities should proceed

with the restructuring of the telecommunications, transportation, and energy sectors as a matter of urgency.

As for fiscal and monetary policy, I fully share the staff's view. I particularly urge the authorities to take a cautious approach to the conduct of monetary policy since there seems to be increasing pressure for fiscal loosening.

I also urge them to implement a full set of corrective measures to strengthen expenditure control in order to attain the fiscal targets.

Finally, regarding the extension of the commitment period for the first year ESAF arrangement, I urge the staff to make a strict judgment as to whether all the corrective measures have been fully implemented before deciding on an extension.

Mr. He made the following statement:

Viewed from the historical and regional perspectives, Kenya has indeed come a long way in economic stabilization and structural adjustment. The authorities' success in sharply reducing the overall budget deficit and in containing inflation is commendable. Implementation of structural measures aimed at eliminating economic distortions through liberalization of trade and exchange regimes and divestiture of government from economic activities has substantially improved the environment for private investment. However, the authorities are still faced with formidable challenges in addressing poverty. About half the rural population is living in poverty, and has no access to the minimum requirement of food and essential nonfood commodities. There has been no evidence of reduction in the 25 percent urban unemployment. Real per capita GDP growth, which turned positive for the last two years, still fell short of offsetting the decline in previous four years. In this context, it is unfortunate that the original program growth rates for the medium term had to be revised downward. While the staff's cautious assumptions are appreciated, it is highly possible for the authorities to out-perform the revised baseline growth projections, provided they pursue further fiscal consolidation, tight monetary policy, and a flexible exchange rate policy as well as accelerating structural reforms. In these areas, I have little to add to the recommendations of the staff and previous speakers.

Regarding public finance discipline, we welcome the timely warning by the staff and the authorities' corrective measures. Nevertheless, it is important to distinguish the irregularities caused by bad policy or weak rules from those that are considered violations of sound policies and rules, as they may differ in assessment and remedy. The staff's comments would be appreciated. In the former case, attention should be focused on improving the policy and institutions while in the latter case, emphasis should be on enforcement and I need some clarification as to whether individual violations are regarded as deviating from good program implementation when they are followed with strong remedial measures. However, since severe and repeated irregularities in either case may cause disruption to policy implementation and undermine

investor confidence, adequate care is needed to prevent them in the first place and increasing transparency of rules as well as of enforcement is clearly a necessary step in this direction.

With these remarks, I support the proposed decision and hope the authorities' determined efforts will lead to an early conclusion of the mid-term review.

Mr. Konan made the following statement:

I am pleased to note from the staff report and Mrs. Guti's very helpful statement that the Kenyan authorities have steadily pursued their adjustment efforts and made substantial progress toward macroeconomic stabilization. Thus, in 1996, the momentum of economic growth was maintained, inflation continued to be relatively low, the external account position improved somewhat and the primary fiscal balance continued to register a surplus for the fourth year in a row. Moreover, through the strong implementation of structural reforms, progress has been achieved in the liberalization of the economy and the promotion of the private sector. All these achievements are a testimony of the authorities' commitment to their adjustment program for which most of the performance criteria and benchmarks for end-June and end-September 1996 have been met. The corrections being implemented in some areas showing weaknesses so as to meet the end-December benchmarks also add credibility to the authorities' ongoing efforts.

Despite these encouraging achievements, I share the staff's views that there is a need to address more forcefully the key structural bottlenecks that constrain the development of the Kenyan economy. In this regard, priority should be given to accelerating the reform of public enterprises and to further consolidating the public finances.

There is no doubt that Kenya has shown, over the past years, a good record of macroeconomic and structural adjustment. In that regard, the authorities need to build on the momentum of reforms already achieved and accelerate implementation of economic measures and structural reforms including more fiscal transparency and a better containment of inflation pressures, so as to reassure private sector confidence in the economy and to secure a sound path to growth. It is therefore encouraging to learn that discussions focused on financial and structural measures aimed at achieving performance criteria and benchmarks.

Since I am in broad agreement with the staff appraisal and share most of their policy recommendations as well as comments made by previous speakers, I will limit myself to the fiscal sector and the ongoing reform of parastatals.

First, on fiscal policy, I welcome the objective of further reducing the fiscal deficit to 1.2 percent of GDP in 1996/1997. I note that this objective is expected to be achieved through a broadening of the tax base, an improvement in tax administration and a strict control as well as a reduction of outlays. On

the latter, while the cuts envisaged in expenditures including the additional retruchement of some 8,000 civil servants appear courageous, the authorities should be commended for their readiness to make further cuts and take additional revenue measures if necessary.

In Table 8 of the staff report, I noted that several measures, including reduction of import duty rate, improvement of administration of Kenya Revenue Authority, no general increase in wages and allowances for civil service are to be implemented in the 1996/97 budget for a further consolidation of fiscal performance. It is not yet clear to me how these measure would help the authorities to achieve that objective and bring fiscal deficit to GDP down to 1.2 percent. Staff comment and assessment would be appreciated.

Second, on public enterprise reform, the authorities deserve to be commended for the progress achieved in improving financial performance of major enterprises such as the Kenya Port Authority, the Kenya Power and lighting Company and the Kenya railways and also for their increasing withdrawal from activities related to agriculture, petroleum and financial sectors. Moreover, I note that at end-December 1996, 21 divestitures of nonstrategic enterprises were completed out of 40 and no progress was recorded for two other key enterprises. In that connection, I welcome the authorities' intention to accelerate the privatization process in the course of this year and their stated intention to begin with those enterprises having a significant macroeconomic impact.

Experience has shown that the privatization process is not an easy one; therefore, we should not see the gradualism in the approach of the authorities as a lack of commitment because in many instances, the buyers' willingness to take over the concerned enterprises takes time to be materialized.

With these remarks, I wish every success to the Kenya's authorities.

Mr. Daïri made the following statement:

Kenya's economic performance continues to be very good. Prudent macroeconomic policies and far-reaching structural reforms have enabled relatively high rates of growth, moderate inflation, and a strengthened external position. While I support the thrust of the staff's recommendations, I regret the noncompletion of the midterm review under the first annual ESAF arrangement.

I encourage the authorities to strengthen their efforts in dealing with cases of misappropriation of public funds, as referred to by Mrs. Guti in her helpful statement. This would help improve their relations with the donor community and strengthen private sector confidence. However, I agree with Mr. Autheman that the Fund should not be involved in auditing procurement contracts. I hope that with the wide structural reform agenda under way and the authorities' strong track record of prudent macroeconomic policies and structural reform, it would be possible to reach an early completion of the midterm review under ESAF. Continuity of close cooperation with the Fund,

including concessional Fund financial support, will help maintain the adjustment and reform process.

I wish the authorities success in their endeavors.

Mr. Gruber made the following statement:

Despite undeniable substantial progress in macroeconomic stabilization in particular, but also in structural reforms, Kenya has so far not succeeded in moving to a higher growth path, as it had been expected during the discussion of the current ESAF arrangement. The reasons for this seems to lie mainly in the slow progress of some critical structural reforms, the lack of discipline in public finances, and the corruption which led to infrastructure bottlenecks, a deterioration of the business environment and a decrease of investors' confidence. Subsequently, the optimism of the authorities and the staff, which inspired the approval of the ESAF arrangement, seems, unfortunately, to have been replaced by a certain pessimism regarding the capability of the country to take the necessary steps toward a sustained higher growth path. This pessimism is nourished by dangers for the stabilization and the restructuring process arising from the upcoming presidential and parliamentary elections.

As outlined in the staff report, Kenya has the clear potential to benefit from globalization of trade and finance, and thus sustain a higher rate of economic growth. That it is possible to attain a sustained higher growth rate has, furthermore, also been proven by other countries in the region, which took decisive action in improving the economic framework and fostering structural reforms. We agree with the staff appraisal that the challenge facing the authorities is to unleash the economic potential and urge, therefore, the authorities to take strong measures to regain the momentum in the public enterprise reform and privatization programs, to ensure discipline and transparency in public finances and to eliminate corruption. Such actions would assure the public and investors that the government will sustain the ambitious program of economic reforms and carry the process of economic transformation through to completion.

The continuing drought is an additional handicap which will certainly complicate the further implementation of the macroeconomic stabilization policy as well as structural reforms. In this respect, we welcome the efforts of the authorities to compensate for the additional spending in 1996/97 resulting from the famine relief program although we regret the possible negative effects on development expenditures, which will perhaps have to be curtailed. We welcome, furthermore, the recent implementation of the measures with regard to the privatization program and hope that the authorities will take the necessary additional decisive actions in the management of public resources and the implementation of outstanding structural reforms to allow the staff to complete the discussions on the midterm review under the first annual ESAF arrangement.

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

Mr. Hamilius made the following statement:

The staff is correct in stating that Kenya's economy has reached a critical juncture. There has been commendable progress under the current ESAF program, but much more still needs to be done. Though the first months of the present program have seen some improvement in the fiscal and monetary areas, structural reform is as usual lagging far behind. It is absolutely necessary for Kenya to regain the confidence of investors and create an environment more favorable to growth, if there is to be any hope for the country to live up to its great potential. I therefore hope that the government will rigorously implement all the necessary measures in spite of the general elections.

The staff has identified the areas where progress is most needed. I will comment briefly on some fiscal and structural issues before asking the World Bank representative for further precision.

I welcome the efforts during recent months to restore some fiscal discipline. It is unfortunate that the old demons of financial irregularity and diversion of public funds have reappeared. Let us hope that the authorities can put an end to such behavior. And although in Kenya, as elsewhere, the mills of justice grind slowly, we must hope that most of the diverted public monies can be recovered. Here the new resident advisor to the Treasury should be in a position to make the management of public expenditures more efficient. Restoring fiscal discipline is an essential prerequisite to the restoration of confidence.

Despite praiseworthy efforts on the structural side, the bulk of Kenya's structural program is still to be implemented. Continued privatization of state-owned enterprises will help ease the fiscal burden. Improved control over the parastatals is needed to prevent quasi-fiscal operations from endangering the fiscal position. I strongly urge the authorities to step up the pace of privatization.

I note from page 47 of the report that the disbursement rate of IDA loans is once more very low. This is troubling. Indeed, one would expect that there would be coordination and parallelism between progress under IDA programs and the Fund's ESAF programs. But this has not been the case with the current ESAF, nor for its two predecessors.

Obviously, slow progress in many sectors covered by IDA loans is the reason for the low disbursement of those loans. It explains why the staff, in paragraph 27 of the report, expresses concern that inadequate public services in the energy, telecommunications, and transportation sectors, all covered by IDA loans, are still a serious impediment to the achievement of a high and sustainable growth in Kenya. I would appreciate it if the representative of the World Bank could elaborate on this situation.

I support the staff's plans for future negotiations with the Kenyan authorities, as well as the proposed decision. I wish the authorities courage and tenacity in their future efforts to implement the program.

The staff representative from the African Department explained that the ESAF review had not been completed because it had become apparent during the staff visit that most of the benchmarks for end-December were unlikely to be completed on time. At that juncture, only two of the five end-December structural benchmarks had been completed. The noncompletion of the review was not due merely to shortcomings in the financial management of public resources, but related primarily to the implementation of structural policies as defined by the benchmarks.

Furthermore, the original letter of intent had envisaged that the midterm review would cover explicitly the implementation of policies relating to the transparency of public finance, the staff representative continued. Part of that undertaking concerned the transparency in the award of public contracts. It was in that context that the staff approached the awarding of the power contracts—not to judge the relative merits of individual power contracts, but rather to determine whether the internal procedures for awarding the contracts had been followed and whether transparency had been ensured.

The ESAF had been playing a key role in Kenya's efforts to achieve a higher and sustained growth path, the staff representative indicated. The country had made commendable progress in fundamental reform, which included fiscal consolidation and market liberalization, but in order to ensure high and sustainable growth, private investment needed to increase. The challenge for the authorities was to create conditions conducive to higher private investment. Investors cited three factors that they considered relevant to their decision making: macroeconomic stability, infrastructure constraints, and corruption. ESAF had played an important role in the achievement of macroeconomic stability. The inclusion of structural aspects in the ESAF was designed to address the country's infrastructural constraints and shortcomings, and to lend support to the World Bank's initiative in that area. Many potential investors considered corruption as a major deterrent to higher investment in Kenya, because it created an atmosphere of uncertainty. That was the reason that problem was being addressed in the context of the ESAF, with a view to enhancing the credibility of government economic policy and strengthening domestic saving and private investment. Credibility could be enhanced only if the public could clearly see that its major areas of concern were being addressed.

The Acting Chairman wondered whether the program was seen as the Fund's response to investors' concerns, or whether ownership of the program was considered important for the sustainability of policies and especially of performance.

The staff representative from the African Department indicated that from the beginning the staff had striven to ensure that neither the Fund nor the Bank was imposing the policy prescriptions. It had taken 9 to 10 months to finalize the policy framework paper because the process had involved discussions with most of the ministers, and the draft had also been discussed by the cabinet. Later on, all the matters had been discussed with the authorities at a retreat. The consultative process had ended with the publication of the policy framework paper by the government, under the signature of the president. While the Fund and the World Bank had been providing policy advice, the fundamental economic policy debate, aided by the publication of the policy framework paper, had been taking place between the government and the public. The delays in the timetable for implementation were primarily a reflection of shifts in the authorities' priorities.

Mr. Newman noted the staff's arguments about the usefulness of the Fund's continued engagement with Kenya as a means of enhancing credibility and confidence. Nevertheless, the Fund's own rules suggested that it should become involved only in the case of a balance of payments financing need, and the staff's forecast indicated little or no balance of payments need. Most of the proposed measures designed to enhance credibility were structural in nature, which raised the question of the relative roles to be played by the Fund and the Bank.

Mr. Autheman echoed Mr. Newman's concerns. While the policy and the strategy proposed by the staff appeared sound in the context of Kenya, it raised the question of whether it could be pursued on an experimental basis. Would the approach be consistent with the Fund's existing policies and rules, in particular with the requirement of balance of payments need, and with the limit imposed on the number of ESAF arrangements for a single member?

Mr. Donecker suggested that the Fund should be mindful of the fact that there were many other countries in need of the Fund's scarce resources. It was important to maintain a delicate balance between the desire to assist Kenya and the need to channel low-interest financing to the countries that needed it most.

The Acting Chairman noted that, given Kenya's importance within Africa, in terms of its size, history, and geographic location, developments in Kenya had a profound impact on other African countries.

Mr. Newman agreed with Mr. Autheman that Kenya's case presented the broad policy issue of the continuing role of ESAF, made more difficult by the fact that Kenya, unlike other countries, did not face a balance of payments problem.

Mr. Shields cautioned against attempts to rank countries in terms of the seriousness of the balance of payments need as a means for determining which of them should obtain financial assistance. The programs were designed for countries below IDA or ESAF thresholds. The discussion of Kenya's case seemed to highlight the need for a flexible program, such as precautionary ESAF, that would provide the seal of approval for the authorities' policies in the absence of an immediate balance of payments need. Should the situation change, and the country be hit by adverse shocks, it would still be eligible for concessionary finance.

Mr. Donecker, noting that Kenya was using a third ESAF, stated that there were limits to how far the Fund should be prepared to go in supporting a country with an ESAF—particularly as there were other countries undergoing adjustment that needed the very low interest rate resources much more urgently. The essential question remained whether a genuine balance of payments need existed. Perhaps, in the case of Kenya, there was a role for a precautionary Stand-By Arrangement.

Mr. Daïri remarked that, given the expectations of further structural adjustment and liberalization, short-term balance of payments difficulties could not be ruled out. For example, a reduction in import tariffs could have a short-term negative effect on Kenya's balance of payments. While much remained to be done in the structural reform program, it would not be balanced for the Fund to insist on close cooperation and program monitoring without providing adequate resources at the same time. Furthermore, individual slippages in policy

implementation should not be construed as a failure of the program. It might merely suggest that some measures had turned out to be more difficult to implement than others.

Mrs. Guti said that she was concerned about the implication of Mr. Donecker's comments that Kenya's use of Fund resources would be at the expense of some other African countries. After all, Kenya was an ESAF-eligible country. Furthermore, even though Kenya did not have an immediate balance of payments need, the country's balance of payments position remained vulnerable in the short term, in light of its heavy debt burden and short-term capital flow volatility. Kenya was also suffering from a severe drought which necessitated development expenditure cuts. The authorities were hoping for drought relief from the donor community—in that context, cooperating with the Fund and maintaining the program on track were critical to continued donor funding. It should be noted that difficulties encountered in implementing programs were not unusual. Some of the measures, such as privatization, involved difficult political choices. In no way should the delays in policy implementation be construed as lack of commitment by the authorities.

Mr. Leijdekker remarked that, in the context of ESAF countries, the concept of balance of payments vulnerability was perhaps more relevant than the balance of payments need. If those countries reached lower current account deficits and comfortable levels of foreign exchange reserves, it was only with substantial donor support. Over the longer term they still remained vulnerable to fluctuations in primary product export prices. The concept of a precautionary ESAF arrangement appeared to deserve a closer look, especially in light of the concerns expressed by Mr. Donecker about the need to economize on scarce resources. A precautionary Stand-By Arrangement, which had been used in the case of Lesotho, might not be as effective in addressing the more subtle policy problems alluded to by Mr. Autheman and Mr. Newman.

Mr. Newman considered that a precautionary Stand-By Arrangement would not be appropriate for Kenya because the country qualified for concessionary financing in light of its low per capita income.

Mr. Donecker said that Kenya had received valuable support over many years. Perhaps the time had come to shift the responsibility for the provision of the assistance from the Fund to the World Bank, and to regional development banks.

Mr. Chelsky stated that he fully supported Mr. Autheman's suggestion for the incorporation into the work program of a discussion of the mechanism of Fund involvement in cases such as Kenya's. That would allow the issue to be discussed more fully than in the context of the Article IV review.

The staff representative from the African Department indicated that the issue of Kenya's balance of payments need arose when the ESAF arrangement had been approved a year earlier. At that time, the Board had taken into account Kenya's balance of payments vulnerability, including the level of foreign exchange reserves. In the end, the Board had agreed to provide a low-access ESAF—75 percent of the quota for three years. It had also approved the target for the growth in foreign exchange reserves to 4.3 months of imports by the end of 1998. At the end of 1996, the reserves had stood at 3.6 months of imports, better than initially expected, but still below the target approved by the Board. While the balance of payments situation had improved, it had not changed so fundamentally as to warrant a review of the original framework approved by the Board.

The staff representative from the Policy Development and Review Department indicated that even though the purpose of the ESAF included balance of payments support, it did so in a broader context than a Stand-By Arrangement—namely, to achieve a sustainable balance of payments and growth. That was also the reason that the ESAF program, when approved, considered the future path of balance of payments and the associated financing need.

The ESAF procedures allowed for the review of each annual arrangement, including the extent of access, the staff representative continued. The policy regarding the changes in access in response to the balance of payments was asymmetrical. In the case of a deterioration, the Board could agree to increased access; in the case of an improvement, the Board could agree to a reduction in access, but only in a situation where the developments were substantially more favorable than had been envisaged.

The staff representative from the African Department indicated that the government's budget included a contingency fund of about 1 billion shillings, designed to protect essential expenditures such as health. The revenue measures taken by the government had been consistent with the revenue targets, and thus far the revenue collection had been broadly on target. Generally, a reduction in import duties and in the value-added tax rate did not lead to significant revenue losses, because it tended to lead to improved compliance. Kenya's tax ratio still remained very high, and the goal was to reduce it over time.

The financial irregularities did not stem from the absence of an institutional framework—rather, they had occurred as a result of the violation of the rules, the staff representative concluded.

The staff representative from the Policy Development and Review Department said that, generally, a review involved both a backward-looking review of performance and achievements, and an immediate and forward-looking assessment of prospects for continuing implementation. Both considerations were equally important—meeting all targets did not guarantee by itself a review completion. Public financial management, financial irregularities, and transparency were part of the backward-looking review, but they also had a forward-looking dimension. Were they among the factors that could interfere with the ability to implement the program? It was clear that some of those factors had an economic impact as they raised questions about investor confidence and about the prospects for continued investment and growth. Consequently, they had to be part of the consideration for completion of any review.

The idea of a precautionary ESAF was now under consideration by the staff. In the spectrum of existing instruments—staff-monitored programs, precautionary Stand-By and Extended Arrangements, low-access ESAF, and ESAF—a precautionary ESAF would likely lie between Extended Arrangements and low-access ESAF.

Mrs. Guti emphasized that the authorities had demonstrated their commitment to reform by implementing the current program. They were equally committed to redressing the financial irregularities and were taking all necessary action. The completion of the ESAF review would be in Kenya's best interest. It would also be in the Fund's best interest in its relationship with Kenya because it would avoid interruption in the program. It was important that the Fund should not be perceived as penalizing its successful members. Rather, the Fund should provide encouragement to its members' efforts. The Fund's flexibility and its readiness

to assist the authorities to assume ownership of the program was an important source of success as well.

The Acting Chairman remarked that the Board's goal was to transform good students, like Kenya, into the best students.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the substantial progress made in macroeconomic stabilization and the strengthened external position. They regretted, however, the delays in implementing reforms in several critical structural areas, and stressed that accelerated and comprehensive structural reforms were needed to enhance investor confidence and put Kenya on a sustained higher growth path. In particular, Directors urged the authorities to vigorously pursue fiscal consolidation and civil service reform, push ahead with public enterprise reform and privatization, and strengthen efforts to eliminate corruption and improve discipline and transparency in the management of public finances. Decisive action in these areas would demonstrate the government's commitment to complete the process of economic transformation.

Directors welcomed the targeted reduction in the overall fiscal deficit envisaged under the 1996/97 budget, as well as the measures taken to enhance the quality and sustainability of fiscal adjustment, especially the reduction in value-added tax rates and in import tariffs and improvements in the quality of expenditure. They expressed concern, however, about the recurrence of large and unanticipated outlays, the continued problems encountered in expenditure management, and the prospect of additional expenditure pressures in the second half of the fiscal year on account of drought relief. They urged the authorities to strengthen expenditure control and promptly put in place compensating measures to ensure the achievement of the fiscal targets for 1996/97. In that context, the need to resist pressures for spending in the run-up to the elections was emphasized.

Directors were disappointed that financial irregularities had continued to surface, and that past cases of misuse of public funds remained unresolved. They welcomed the remedial steps taken in several areas, but emphasized the need to address all cases of misuse of public funds. While noting the elimination of a large number of ghost workers, Directors urged the rigorous pursuit of civil service reform to establish a competent and professional administration dedicated to the public interest and strict discipline in public finances.

Directors stressed the need to maintain a restrictive monetary policy and greater flexibility in exchange rate management in response to capital flows to avoid recourse to substantial sterilized intervention. They pointed out that the possibly excessive sterilized intervention in the past, lack of competition in the banking sector, and the risk perceived by investors had contributed to the excessively high real interest rates, which were detrimental to investment and growth. Directors cautioned that, with potential upward pressures on prices

due to the drought and an uncertain economic environment in the run-up to the elections, vigilance in the conduct of monetary and exchange rate policy would be needed. They encouraged the authorities to enact the Central Bank of Kenya (Amendment) Act as soon as possible to provide for greater central bank independence.

Directors regretted that progress in the privatization program and the restructuring of key public enterprises had been slower than expected. They stressed that it was critically important for the authorities to pursue with firm determination the privatization and public enterprise reform programs, as inadequacies in power, rail transport, telecommunications, and other basic services remained key factors constraining economic growth. They therefore welcomed the decision to proceed with the reform of the telecommunications sector, and urged the authorities to move ahead more broadly and ensure strict transparency in the process of privatization.

Directors emphasized that sufficient progress in implementing the remaining corrective measures relating to parastatal reform and discipline in public finances was needed to complete the discussions for the midterm review under the first annual ESAF arrangement. They considered that the Fund continued to have an important role to play in supporting Kenya's reform efforts. Some Directors suggested that the modalities of that support should be considered further.

Directors encouraged the authorities to improve the timeliness in compiling and reporting statistics, particularly the balance of payments and national accounts.

It is expected that the next Article IV consultation with Kenya will take place on the standard 12-month cycle.

The Executive Board took the following decision:

1. The Fund takes this decision relating to Kenya's exchange measures subject to Article VIII, Section 3, in the light of the 1996 Article IV consultation with Kenya conducted under Decision No. 5392-(77/63), adopted April 29, 1997, as amended (Surveillance over Exchange Rate Policies).

2. As described in SM/97/70, Kenya's outstanding commitments under the Exchange Risk Assumption Fund (ERAF), which was abolished in June 1994, give rise to a multiple currency practice subject to the Fund's approval under Article VIII, Section 3. In view of the abolition of the ERAF, and of Kenya's intention not to enter into any new commitments under the ERAF, to clear all outstanding commitments as they mature, and to eliminate the multiple currency practice by 2003, the Fund grants approval of the

retention of the multiple currency practice until March 21, 1998, or the conclusion of the next Article IV consultation with Kenya, whichever is earlier. (SM/97/70, 2/28/97)

Decision No. 11462-(97/26), adopted
March 21, 1997

5. GEORGIA—1997 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY—SECOND ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1997 Article IV consultation with Georgia and Georgia's request for the second annual arrangement under the Enhanced Structural Adjustment Facility (ESAF) (EBS/97/29, 2/27/97; and Cor. 1, 3/19/97), together with a policy framework paper for the period 1997–1999 (EBD/97/20, 2/25/97). They also had before them a background paper on recent economic developments in Georgia (SM/97/71, 3/3/97).

The staff representative from the European II Department made the following statement:

> Developments in early 1997 indicate that the ESAF-supported program remains on track. Available information suggests strong output and continued progress on the stabilization front. The inflation rate for the year ending in February was 12 percent, compared to 14 percent during 1996 and about 57 percent in 1995. International reserves stood at $136 million at the end of January, in line with program targets. As of end-February, the exchange rate was lari 1.29 per U.S. dollar, compared to about 1.28 at the end of 1996.
>
> All prior actions under the program have been met.
>
> Regarding financing assurances, debt "rescheduling agreements consistent with program assumptions were signed with all but two pre"1995 bilateral creditors. China and Turkey have agreed that, pending the conclusion of rescheduling agreements, Georgia would not be required to make debt"service payments.
>
> The 1997 budget, approved by Parliament on February 21, is consistent with program assumptions. The overall deficit, on a commitment basis and including grants, is targeted to decline to 2.8 percent of GDP in 1997 from 4.5 percent in 1996.
>
> Parliament approved the value-added tax chapter of the new draft tax code on second reading on March 7. The draft introduces an invoice based value-added tax and places value-added tax on a destination basis for all countries. Despite intensive pressure from some fractions of Parliament, only a few minor exemptions were added to the draft; these will need to be clarified during the third and final reading.

Restructuring programs have been agreed with the former state banks. The Agrobank has been placed under new management and the government has sold its remaining shares in the United Bank of Georgia.

The NBG and the MoF have issued the necessary instructions for the transfer of the revenue accounts of the State Tax Service (STS) and Customs Department to the government account at the NBG, which is taking place during the month of March.

The coverage of the Large Taxpayer Unit has been expanded to 209 taxpayers.

More than 9,000 active taxpayers were identified in 1996.

All tax policy measures agreed under the program have been implemented, except that automobile imports from CIS countries have not been made subject to the same value-added tax and customs tariff imposed on non-CIS countries; this measure is expected to be implemented in the context of the new tax code, which is to be enacted by June 1, 1997.

Revenue performance in January was disappointing, but improved considerably in February. Although tax revenue during the first two months of the year was below program targets, in real terms tax revenue was more than double its level in the same period in 1996. The authorities expect to make up for most of the shortfall in March and may be able to meet the first quarter revenue target, although this now seems unlikely. In the meantime, they have sequestered nonessential outlays, especially capital expenditures, and have observed program targets on domestic bank financing of the budget. In case the first quarter budget review indicates a revenue shortfall, the government and the Parliament are committed to cutting expenditure authorizations accordingly, in line with understandings under the program.

Progress in developing a Treasury system has been somewhat slower than anticipated. The authorities are committed to accelerating the process, with technical assistance from the Fiscal Affairs Department. The authorities have agreed to include into the Treasury system the budgetary accounts of all spending units, as well as the five special State Funds by end-June 1997; all regional accounts of the central government by end-July; and any remaining accounts of central government spending units by end-August.

Since recent developments and the policy actions taken by the authorities are in line with the program, the staff reiterates the views expressed in the appraisal included in EBS/97/29 and recommends approval of Georgia's request for a second annual arrangement under the ESAF.

Mr. Yakusha made the following statement:

On behalf of my Georgian authorities, let me express their sincere gratitude to the staff for the valuable assistance and the advice they have provided so far, as well as for their efforts in preparing the comprehensive

reports on Georgia, which describe very well both the economic achievements and the challenges that still lie ahead. In addition to that, my Georgian authorities are especially thankful to the Fund's management for helping the country to normalize the relations with its creditors and to secure the full financing of the program throughout 1997. The Georgian authorities have greatly benefited from cooperation with the Fund and the Fund's overall role in stabilizing the economy is deeply appreciated.

Based on the achievements of the implementation of the program during 1996, my authorities are requesting the Fund's support for the program of economic policy measures under the second year of the ESAF arrangement.

The strengthening of Georgia's track record on stabilization and structural reforms has continued at an impressive pace. According to the revised estimates, real GDP growth during 1996 was around 10.5 percent—significantly higher than the 8 percent envisaged by the original ESAF arrangement. The latest data on economic activity in January 1997 suggest that growth has further accelerated compared with the respective period in 1996. The downward trend of inflation has also exceeded the original program expectations by a substantial margin and the record has remained rather satisfactory: inflation was 14 percent over 1996 compared to 57 percent in 1995. In addition, the adherence to sound monetary policies and the restructuring of the financial sector, as well as the completion of the small-scale privatization program and the privatization of over half of the large state enterprises, are serious pillars for sustaining the momentum of financial stabilization in 1997. Tenders and cash auctions open both to domestic and foreign investors will be the primary methods of privatization.

It is necessary to point out that the improvements in macroeconomic stability in 1996 were achieved by simultaneously addressing rather important social goals. Within the education and health care sectors, dollar wages increased significantly since the beginning of the stabilization efforts in late 1994. One of the priorities in the 1997 budget deals with the basic education and health spending, and it is envisaged that the efforts undertaken during the first year of the program's implementation are to continue in order to reverse a decrease of the relative size and quality of these essential services, which occurred during the hyper inflationary episode of 1993–94. During 1995, the shares of overall expenditures on these two items were increased to 5.1 percent and 6.7 percent, respectively. Although the final data for 1996 are not available yet, there are indications that the upward trend has continued. According to the staff's estimates, the expenditures on health and education in 1997 are budgeted to reach even higher levels, amounting to 18 percent of the total central and local government expenditures, or 6.5 percent and 11.5 percent, respectively.

The achievement of even lower inflation in 1997 is to be supported by various economic policy measures. Among these, the maintenance of a stable exchange rate has an important role. The authorities fully agree with the staff's assessment that the current exchange rate policy has served Georgia well and that it has contributed a lot toward restoring the overall confidence in

governmental policies. In this light, the exchange rate will be allowed to appreciate in case net international reserves rise substantially over the program targets.

Georgia became an Article VIII member toward the end of the first yearly arrangement under the ESAF program, and my authorities are fully committed to maintaining current and capital account convertibility. In order to provide for more transparent and liberal terms in accessing the domestic market, a new Foreign Investment Law, drafted in collaboration with the World Bank, became effective in December 1996. The changes in the regulation of exports envisaged for 1997 will be in line with this stance. A further decrease in the relative size of the current account deficit is envisaged, bringing it down to about 7 percent of GDP. It is envisaged that the main factor behind such a development is a continued recovery of exports, which has been recorded to date. However, the external sector developments in 1997 and onwards will still depend highly on continued balance of payments support in the form of grants and loans on the one hand, and on the creditors's approval to debt-service rescheduling of the pre-1995 debt on the other. Further external support on concessional terms would facilitate the implementation of the envisaged structural reforms and it would be perceived as an additional sign that the authorities' policies continue to follow a favorable path. My authorities will continue to honor their obligation to deposit funds in the special account with De Nederlandsche Bank and they have already started making the appropriate debt-service payments by using the funds from this account.

Further efforts are envisaged to continue the banking sector restructuring, and to consolidate the results that have already been achieved in this respect. Prudential regulations are to be strictly enforced and, according to the consolidation program, the number of banks (62 by the end-1996 compared to over 100 at end-1995) is to be further reduced through, inter alia, the closing of noncertified banks in an orderly manner. Progress in completing the financial sector restructuring will be monitored, it being one of the structural benchmarks.

The authorities are fully aware that compliance with the program targets for 1997 would be impossible to achieve without the new effort on the fiscal front. In order to attain a more sustainable fiscal position and to reduce the dependence of government finances on external loans and grants, the main objective for 1997 will be to further reduce the overall deficit. According to the preliminary data, the overall deficit of the public sector has fallen from 5.3 percent of GDP in 1995 to 4.5 percent in 1996. It is envisaged that the deficit will further decrease to 2.8 percent of GDP during 1997, while all outstanding arrears as of January 1, 1997, are expected to be eliminated by year-end, thereby continuing the trend established throughout the first year of the program. Improvement of revenue performance remains an important task for the period ahead, and in addition to the increase in tax collection by 3 percentage points of GDP in 1996 compared to 1995, my authorities would expect a further increase of 2.5 percent in 1997 as a result of numerous improvements in tax and customs administration. On the expenditure side, the

tight stance for 1997 will be accompanied by an improvement in the quality of the fiscal adjustment. Further cuts are expected in the number of public sector employees, thus reducing the number by some 40 percent since late 1994, while providing the incentives to recruit and to retain quality staff. This would further contribute toward institution building efforts of my authorities and toward improving the quality of governance in Georgia.

While these efforts have been setting the stage for further healthy growth and a financially stable economic environment, there are still numerous challenges ahead for my authorities. They stand prepared to enforce additional measures in case of the emergence of risks that could endanger the comprehensive implementation of the program and they are ready to maintain a continuous working dialogue with the staff in this respect.

Mr. Coumbis made the following statement:

Under an ESAF Arrangement Georgia's economy is improving in quite a satisfactory way, showing, in 1996, high growth rates, declining inflation, decreasing current account deficit, and structural reforms advancing at an accelerated rate. It is an impressive performance, if we take into account that just a few years ago Georgia was at civil war with severe destruction in many sectors of the economy, hyperinflation, high current account deficits, and high external debt and arrears. All this indicates the strong commitment of the authorities to rapidly adjust their economy to a sustainable course of rapid growth and slow inflation. I am confident, therefore, like the staff, that the authorities will be able to attain the very ambitious targets of the 1997 ESAF Arrangement with the financial and technical assistance of the Fund. I am in broad agreement with the staff appraisal and policy recommendations, therefore I will examine just a few issues concerning fiscal policy and structural reforms.

On fiscal policy, the staff indicates that Georgia's stance was rather loose in '96, because they missed the target for fiscal deficit by 0.8 percent of GDP. The basic policy weakness of this economy, as of many other transition economies, is the weak performance of fiscal revenue and hence the inability of the authorities to increase public expenditure in areas such as health, education, and safety nets, which are considered of primary importance for an extensive segment of the population. I would like to stress, however, that the budget revenue increased to 8 percent of GDP in 1996 from 5 percent in 1995 and 2.4 percent in the first half of 1994.The progress is impressive, and in 1996 it was due mainly to better collection of taxes through administrative improvements in the tax and customs departments, removal of most tax exemptions, and the introduction of new taxes. The increase in revenue enabled the authorities to increase expenditure by 1.7 percent in important areas, to counterbalance the decrease of grants from donor countries by ¾ percent of GDP, and to decrease the budget deficit by 0.8 percent of GDP. The introduction of a Treasury Department substantially improved expenditure control in 1996. However, there are still many deficiencies, from the point of view of both prioritizing expenditure and eliminating arrears. For 1997 further administrative and tax measures are expected to increase total revenue by

2½ percent of GDP. I am not convinced that reduction of certain excise taxes will reduce incentives for tax evasion, especially since tax evasion is taking place mainly in income taxes and not it excise taxes, where tax evasion is much more difficult. Some comments from the staff would be welcomed. Furthermore, the enactment of a new tax code and a new customs code is expected to further improve tax collection. As for expenditure control, it seems that the taking over by the Treasury of expenditure accounts from the spending units is proceeding at a slower pace than expected. We hope that it will be fully implemented in 1997. For that year total expenditure is not expected to increase more that 0.3 percent of GDP, and this increase will be directed mainly at health and education. A further reduction of government employees by 6 percent is expected in 1997, which implies a total reduction of more than 40 percent since late 1994. As for the overall deficit, a further reduction to 2.8 percent is expected in 1997. I was glad to see that in 1996 all extrabudgetary funds were integrated into the State budget. Moreover, after a grant from the EU and a loan from the World Bank, it seems that arrears from expenditure were restricted to ½ percent of GDP. The complete elimination of the arrears problems can be expected when the Treasury project will be completed and a single Treasury account will be established at the NBG.

With respect to structural reforms, in last September's Board meeting we praised the authorities for the impressive progress they had made in many areas and sectors of the economy. This time I would like to stress a few points of special interest in the areas of central banking, commercial banks, privatization of medium and large scale state enterprises, the agricultural sector and the energy sector.

With respect to the central bank, I was glad to see that the progress made in banking supervision was substantial. It seems, however, that in the area of refining existing monetary instruments and moving toward indirect monetary management progress is rather slow. The areas of commercial banks, the bank certification program, the privatization of former state banks, and the special agreement with these banks for restoring their financial viability are progressing at a fast pace. As a result, banks' capital rose significantly in 1996, and the nonperforming loans as a percentage of the loan portfolio declined from 30 percent in 1995 to 7 percent in '96. I was impressed by the fact that the restructuring of the FSB was implemented without resorting to public resources.

With respect to the privatization of medium and large scale state enterprises, I noted from Table 5 (page 16) of the RED that the mass privatization schemes used to privatize these enterprises led to a dispersed ownership, which delayed to a certain extent their restructuring effort. However, a World Bank study comparing the performance of these enterprises with those that were still owned by the state, indicates that the privatized enterprises were performing much better.

In the agricultural sector the reforms gained momentum in 1995, while far-reaching reforms took place in 1996. As a result, private ownership of arable land and land under perennials will amount to 62 percent and 82 percent

respectively. I was a little bit puzzled however by the efforts of the authorities to promote the creation of small credit unions to face the high transaction cost of small scale rural lending and the inexperience of commercial banks in this area. I understand from the RED report that the authorities are restructuring the Agrobank. Isn't it, therefore, more efficient and less expensive to use this bank for the financing of the agricultural sector instead of creating new credit unions? Some comments from the staff on this would also be welcomed.

Finally, with respect to the energy sector, I was impressed with the efforts of the authorities to reform this sector, in which the available capacity by the end of 1996 was less than 30 percent of total installed capacity. A privatization program for electricity generation and distribution companies will be launched in April 1997, while the electricity tariff to households was raised by over 30 percent from January 1, 1997. It is expected that soon the authorities will achieve full cost recovery in both households and individuals, while the collection rate of electricity supplies improved from 20 percent in 1995 to 50 percent in 1996.

With respect to data quality, it seems that much is to be desired. According to the staff, the authorities are aware that further improvements in the quality of statistics are essential to support macroeconomic analysis. Moreover, from Appendix IV we read that data on government finance and on balance of payments are not reported to the Fund, in spite of numerous Fund missions and technical assistance in these areas. Furthermore, in the real sector, annual national accounts are still in preparation, and the consumer price index needs further development. I would like to ask the staff if there is any timetable for when these deficiencies are going to be corrected.

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

Mr. Vernikov made the following statement:

I am glad that Georgia's progress on stabilization was even better than expected. Its illustrations are: the rates of inflation that are very low by regional standards; the two-digit rate of growth, although it started almost from a point of economic collapse; and the credible advancements on the structural front. The authorities ought to be strongly commended for these achievements. Among the factors that permitted this turnaround one should not omit an exemplary cooperation with the Fund.

Turning to the recent economic developments and the program for the next year, I would concur with most of the staff's observations, and only add some points for emphasis.

Despite obvious progress in the fiscal area, I see the current situation as still fragile. It is worrisome that in 1996 around 20 percent of general government expenditures were financed by the central bank, and this year's program projections leave this ratio at the still high 15 percent level. Of course, it represents a tremendous improvement if compared to the situation of

1992–94, but I believe that the authorities must not be satisfied with this comparison alone.

The Georgian stabilization is exchange rate-based, and it is precisely due to remarkable exchange rate stability that the public demand for national currency has strengthened beyond expectations. Nevertheless, monetization of the economy remains low, and even a seemingly manageable fiscal deficit may endanger this precious credibility. Table 8 in the RED paper sums up the TICEX transactions and shows that what the staff defines as the NBG being "a dominant player" practically means that the NBG constantly sells foreign exchange to finance the government, and the pace of sales tends to increase rapidly. A simple calculation reveals that in 1996 these sales provided the NBG with about 75 percent of the funds it needed to finance the fiscal deficit domestically. I am afraid that such a policy is unsustainable in the medium run, and I urge the authorities to address the issue. One must acknowledge that substantial progress has already been achieved in the area of revenue collection as well as in expenditure control. These achievements allow me to believe that the bold target of having all budgetary arrears cleared in 1997 is feasible.

On the revenue side, I note that Georgia's tax system is strongly value-added tax-based. The value-added tax provides about a third of total general government revenues, and this ratio is projected to rise in 1997. I see this as a positive sign. I think that further efforts to streamline and unify the value-added tax and to make it fully invoice-based are very timely and appropriate. I would question the rationale for maintaining differentiated value-added tax rates, namely for bread and flour. The staff notes the abundance of these staples in Georgia, so one may believe that a 10 percent increase would not be fully passed on to consumers.

The budget expenditures are already quite compressed and can hardly offer easy targets for the authorities' efforts to cut the deficit. Nevertheless, further structural reform may still offer some room for rationalization of spending. It is encouraging that the authorities intend to complement the bold health sector reform by a reform of state-run education. It is noteworthy that these reforms are accompanied by the removal of a substantial number of employees from the budget payroll. It might be appropriate for the government to concentrate its limited resources on the primary education, and leave the higher levels less dependent on the public funds. This is quite consistent with the authorities' campaign to better target various benefits. Another possible solution would be to devolve local-level issues, such as primary education and police, to the local authorities, both in terms of administration and of financing.

To conclude with the fiscal issues, I strongly hope that transition to the Treasury system will be completed this year.

The monetary policy in Georgia has been quite cautious thus far, and contributed significantly to the successful stabilization. I broadly agree with the general framework of the NBG operations, and hope that some recent controversial episodes like extension of commercial guarantees by the NBG will not be repeated in the future. It is welcome that the NBG intends to pursue

the fullest possible recovery of these guarantees. Nonetheless, the very fact that they were allowed to occur suggests that legal and actual independence of the central bank still remains an issue in Georgia.

Let me also reiterate a concern about the credit auction practices. It might be that the puzzle of foreign currency deposit rates higher than those for lari is explained by this kind of lending. I note that the format of the auctions seems to allow them to transform into regular interbank loan market.

The banking policy in Georgia deserves close attention. On the one hand, I commend the regulatory authorities for their perseverance in striving for bank soundness. On the other hand, it looks like the bankers community still lacks credibility and trust in the eyes of the Georgian public. The formal banking system performs mostly payment functions rather than intermediation. What would be the staff's view on how the general aversion to keeping savings with banks can be dealt with? In this connection, I was attracted by the idea of promoting credit unions as a local alternative to usual joint-stock banking. I would suggest the staff monitor this development to derive lessons that might be helpful to other transition economies.

Let me skip other structural issues because I basically agree with the authorities' policies.

Before I conclude, let me stress once again the critical importance of external assistance to Georgia. My authorities, when agreeing to reschedule Georgia's debt, took into account this consideration, as well as the strong commitment of the authorities to their reform agenda and to external payments discipline. This Institution has led the concerted international assistance to Georgia, and keeps performing this duty quite successfully. In this context, it is fair to extend our commendations to Mr. Shadman-Valavi who has played a very constructive role in the Fund's dialogue with Georgia and in the process of coordination of external assistance to Georgia.

I fully support the proposed decision and wish the authorities further success.

Mr. Esdar made the following statement:

To put it in a nutshell: Georgia continues its successful ride on the reform track. We commend the authorities for their achievements in transforming the economy: inflation has continued to decline in 1996 to about 14 percent, well below program targets; the exchange rate has remained stable reflecting a cautious and balanced monetary policy; also, the current account deficit has narrowed further; last but not least: structural reforms and here especially the privatization process have proceeded according to schedule.

These reforms obviously have started to pay off and have resulted in a commendable growth performance of about 10 percent in 1996. Increasing foreign direct investment flows signal a growing foreign interest in the country but also that confidence in Georgia's economic outlook is developing.

However, in spite of these encouraging and commendable developments, there are still pressing problems. There is no doubt that important work still lies ahead.

The staff in its excellent report addresses adequately those areas which deserve special attention. I fully share these recommendations and would only like to make some points of emphasis.

There is no doubt that highest priority has to be given to bringing the budgetary situation on a more sustainable level. This in particular would require a significant strengthening of revenues.

While we noted that revenue collection has improved somewhat, we still think that a revenue rate of 8 percent of GDP or a tax revenue rate of only 5–6 percent of GDP is far from being sufficient to bring the budget on a viable footing.

We welcome that the authorities share these concerns and are prepared to strengthen their efforts to improve revenue performance by fostering tax collection and tax administration and to introduce changes in tax policy with the objective to broaden the tax base and to unify the tax structure.

I am not fully convinced that these measures are sufficient to achieve the budgetary objectives. I especially wonder whether revenue shortfalls caused by cuts in certain excise tax rates will be offset by reduced tax evasions and more efficient tax collection. I also doubt whether additional expenditure cuts which are envisaged as a contingency to offset revenue shortfalls would provide an appropriate response.

Already now, public expenditures seem to be squeezed to their potential limits and especially resources earmarked for social expenditures and infrastructure development are insufficient to provide a sound base for Georgia's economic development.

Also, to accept a higher budget deficit would be no solution.

A prudent budgetary planning has to assume that external financial support will remain limited. An increase of the monetary financing of the budget on the other hand would risk jeopardizing the success achieved in bringing down inflation and in stabilizing the exchange rate.

Therefore, a more prudent approach would be to examine whether there is additional room to broaden the tax base or to agree on a somewhat smaller cut of tax rates—at least until we have a clearer picture on the revenue performance. The deviations from the fiscal objectives in 1996 clearly signal the need for such a more cautious approach.

Further on fiscal policy, I am concerned by the attempt to overcome budgetary constraints by accumulating arrears. I would suggest to base

budgetary objectives in future agreements on commitments rather than on cash flows. Perhaps the staff could give us his view on this.

On monetary policy, I do not have much to add to the staff's analysis and recommendations. The informal exchange rate anchor seems to be an appropriate guide for monetary policy. However, we support the view to use the exchange rate flexibly if—due to unforeseen capital inflows—a pressure on the exchange rate should occur while rejecting a downward pressure caused by the inflationary impacts of government credit by exchange rate interventions. This quasi "external financing" of the budget, however, has some limits set by the availability of foreign exchange reserves. A more sustainable financing of the budget would be to prepare the markets for the placement of treasury bills.

Further on monetary policy, or better on central bank policy, we share the concerns of the staff that the central bank under existing regulations is authorized to provide guarantees for imports. We would urge the authorities to abolish these policies as soon as possible.

Finally, on structural policy, I fully endorse the staff's recommendations. Land reform, further progress in reforming the banking sector, the setting up of an efficient supervisory body, and the restructuring of the energy sector should be given highest priority.

To conclude, in light of the encouraging performance under the program, I have no problems supporting the proposed decision.

Mr. Nemli made the following statement:

I commend the Georgian authorities for continuing to build on their impressive progress with stabilization and structural reforms. The encouraging picture of sharply declining inflation, decreasing fiscal and current account deficits and a solid international reserve position was rewarded, in 1996, by a strong revival of growth. In addition, the authorities implemented their structural reforms on schedule and accomplished all the prior actions.

However, Georgia is not yet out of the woods and there is no room for relaxation. Hard work is still ahead to secure the stabilization gains and complete the structural reforms. The public finances remain particularly fragile, notwithstanding the excellent progress under the program so far. Most of the reduction in the fiscal deficit was accomplished in 1994 and 1995 through spending cuts. Since then, the pace of fiscal adjustment has slowed as the room for further cuts was exhausted. Indeed, total spending increased in 1996 by 1.6 percent, while tax revenue rose only by 1.7 percent, to reach the still very low level of 5.3 percent of GDP.

The problems caused by asymmetrical budget management was already visible in the difficulty of meeting some of the end-1996 fiscal targets. Now the only way to preserve macroeconomic stability and build on past gains is to increase tax revenues. The government did well in this area during the program period, but stronger efforts producing a substantial further increase are

essential. In this connection, it will be very important to firmly resist pressures to give preferential treatment to certain taxpayers.

As noted earlier, the limits for further spending cuts have already been reached. From now on, the task will be to rationalize expenditures and maximize their effectiveness. I certainly welcome the authorities' plan to redirect resources toward basic health and education, and to improve the targeting of the social safety net. The authorities are to be commended for attending to important social issues and making every effort to reverse the decline in the living standards of the poor.

The program design exhibits an interesting novelty by introducing minimum spending on health care as a financial benchmark. This is the first Fund program I know of that has established a floor, and not a ceiling, for an expenditure item. Could the staff representative from PDR confirm that this means that henceforward, program design will pay more attention to the composition of expenditures? For my part, I see this approach as entirely in accord with the Interim Committee's recommendations on partnership for sustainable global growth, especially the need to develop human resources as a critical factor in sustainable economic growth. However, let me stress that the efficiency of health care spending is probably more important than the absolute amounts spent. I would therefore like to stress the need for the Georgian authorities to coordinate closely with the World Bank to maximize the effectiveness of its necessarily limited health care budget.

In spite of its prudent macroeconomic policies, Georgia continues to suffer from a balance of payments deficit requiring external financial assistance. The authorities' determination and commitment to stability and structural reforms should make the international financial community more willing to provide this badly needed support.

I wish the authorities every success.

Mr. Andersen made the following statement:

I welcome that Georgia has made considerable headway in its macroeconomic stabilization efforts and in advancing structural reforms under the first annual ESAF Arrangement, and it is very encouraging to note that the endeavors have paid off even in the short term in terms of better than expected outcomes for a number of economic variables, including a double-digit growth rate for 1996. I am also pleased to see that all prior actions for the 1997 program have been met, which bodes well for a continued strengthening of Georgia's track record.

I share the thrust of the staff appraisal and would only like to take up a few points for emphasis.

First and foremost, the state of public finances remains the weakest part of the macroeconomic framework, and to ensure a sustainable increase in revenues will be critical both to ensure an overall strengthening of the public

finances, and to create room for the essential public expenditures that will be conducive to growth in the longer term. In this context, the authorities should be commended for the priority accorded to the quality of the fiscal adjustment, including the emphasis on basic education and health in this year's budget. I, therefore, regret that revenue performance in the beginning of this year has been disappointing, and that it now seems unlikely that the first quarter revenue target will be met. Continued expenditure sequestration is clearly not a sustainable response to weak revenues, and I would not characterize capital expenditures as nonessential expenditures, although I agree that other categories are even more essential. Rather, I would urge the authorities to look into the possibilities of further stepping up their revenue efforts to ensure that the much needed increase in revenues for 1997 is realized as a minimum. On specific revenue efforts, I am not so confident that the reduction of the excise tax rate with the objective to reduce evasion and increase tax collections is timely and prudent. In any case, I agree with the staff that it needs to be ensured that the lowering is translated into improved revenue performance, which may well require increased emphasis on strengthened tax administration. Moreover, faster development of the Treasury would be nothing but beneficial to this process.

Great vigilance is also required by the monetary authorities, as noted by the staff. I regret that the 1996 target for net domestic credit to the government by the banking system was breached, and despite its presumed autonomy according to its Law, the NBG seems to be an important source of financing of the budget deficit, as already referred to by Mr. Vernikov. If this trend continues, there appears to be a risk that the authorities' recent achievements on the monetary front, including lower than expected inflation, may be undermined, and thus the macroeconomic stability jeopardized. I urge the Georgian authorities to ensure that prudent monetary policy will be the order of the day and that excessive monetary financing of the budget, as well as the issuance of financing guaranties like the ones on wheat imports, are avoided.

In order to keep the reform momentum, in the context of present favorable circumstances of lower inflation and growing output, the Georgian authorities should do their utmost to promote private and public savings as much as possible, as they are crucial to the sustained growth of the economy. This, of course, has an important bearing on fiscal policy, but also further development of the banking system would be very important in fostering savings. In this connection, I welcome the priority given to a continuation of the banking sector restructuring and to consolidate the results that have been achieved in this respect. I welcome that the number of banks is to be further reduced, as 62 banks with a very small capital base clearly seems to be excessive for a country like Georgia. I am particularly concerned about the noncertified banks which are still operating and look forward to their closure. The experience from countries in transition in my constituency calls for decisive action as soon as possible. An excessive number of banks in the context of a loose supervision as witnessed by noncertified banks still in operation together with the certified ones, might undermine credibility in the entire system in case of failure of those banks; and should such failures occur,

there could easily be political pressure on the government and on the already underperforming budget. Moreover, loss of public confidence in the banking system may be hard to regain, and private savings, so needed at this stage, would be discouraged. Therefore, I urge the authorities to perform their supervisory responsibilities decisively and to state very clearly to the general public which banks have valid certificates to attract deposits and perform other bank operations. Furthermore, they should proceed with early action on those banks which failed to be certified, in order to prevent possible spillover effect to the whole banking system.

Finally, I would like to emphasize that much more has to be done to build and sustain external confidence and attract new foreign direst investments. I was disappointed to learn from table 21 in the main World Economic Outlook paper to be considered shortly that Georgia is lagging far behind other countries in transition with respect to foreign direct investments which can play a vital role in the transition process.

With these remarks, I support the proposed decision.

Mr. Mahdavian made the following statement:

It is encouraging to see that Georgia has made impressive progress over the last year and that the authorities' determined effort to sustain the pace of stabilization and structural reform has not lost momentum. We are pleased to note that the authorities have successfully implemented the program supported by the first annual arrangement under the present ESAF. This will build on the authorities' strong record of attaining their goal of stabilization and adjustment.

Decisive reform measures and prudent financial management have resulted in a sharp decline in inflation, a strong growth performance, and improved external current account position. Despite these achievements, the economic situation remains difficult. The weak public finances, the problem of the financial system, and the viability of the external position are issues of deep concern.

Success in cutting inflation is perhaps the most important achievement of the reform effort in Georgia to date. Over the past 2-year period, annual inflation has declined from hyperinflationary levels to 14 percent. Continued sound demand management and corrective measures to deal with the structural weaknesses need to be adopted to preserve this achievement.

Georgia needs to strengthen its public finances and keep government expenditure at a sustainable level over the medium term. The fiscal outcome is still short of objective and there is much room for improvement. Heavy reliance on external loans and grants to sustain the government budget in the context of a heavy external debt burden may lead to increased uncertainty about the fiscal position and may cause a serious threat to the process of stabilization and adjustment.

Georgia's balance of payments prospects are likely to remain under strain, even if optimistic projections of exports and disbursement of foreign financing materialize. In this context, all efforts need to be directed toward strengthening the current account position. The measures should aim at enhancing the growth potential of the economy, promoting activities in the export sector, and improving competitiveness.

The staff report has addressed extensively the main policy issues and I am in broad agreement with the recommendations. However, I would like to make some comments for emphasis.

Over the medium term the external debt burden constrains the authorities' room for maneuver and limits the country's growth prospects. In the case of Georgia, even a modest negative deviation from the optimistic projected export growth rates may have significant implications on the external sector. Thus, the same bold policy that has characterized Georgia's approach to stabilization needs to be applied to structural reforms in order to boost savings, increase exports, and stimulate private sector initiative.

As the authorities continue with the current foreign exchange and stabilization policies, energy efficiency gains and the restructuring of enterprises and the agricultural sector would have significant implications for its external viability. In this regard, the importance of a continuation of structural reform measures in the agricultural sector and the provision of financial services to private farmers cannot be overemphasized. Equally important is the commercialization of the energy sector to restore the financial balance of enterprises, rationalize domestic consumption, and attract private sector investment.

Monetary policy instruments have generally been limited to reserve requirements, foreign exchange intervention, and ceilings on credit expansion. We welcome the authorities' intention to issue Treasury bills to expand market-based instruments. We hope that the supplies of Treasury bills are gradually expanded to the public and would replace the sales of foreign exchange to sterilize the strong expansion of credit to government. Issuance of Treasury bills could also help nonmonetary financing of the fiscal deficit and lay the foundation for the development of a government securities market—an indirect instrument of monetary control.

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

Mr. Iradian made the following statement:

The Georgian economy has continued to make progress under the first ESAF arrangement. Economic activity picked up strongly, inflation declined sharply, the exchange rate remained stable, and both the internal and external imbalances narrowed significantly. Significant progress has also been made in the implementation of structural reforms, including the banking sector and privatization. As I am in broad agreement with the thrust of the staff's

appraisal and policy recommendation, I will be brief and address some areas that have already been identified.

The 1997 program correctly aims at consolidating the progress made in macroeconomic stabilization, while accelerating structural reforms in areas that have lagged behind. The targeted reduction in inflation is appropriately ambitious, and will require above all continued firm adherence to restrained fiscal and monetary policies. The scope and depth of the structural policy agenda under the program are impressive and, if implemented fully, should go some way toward creating the conditions for the Georgian economy to become a well-functioning market system.

Further fiscal consolidation should rely primarily on revenue enhancement. Additional meaningful cuts do not appear to be feasible in most expenditure categories, especially in view of the very pressing needs for social outlays and investment in infrastructure to sustain the projected high growth. Substantial improvement in tax and customs administration is needed to achieve the medium-term target of increasing general government revenues (excluding grants) by about five percentage points of GDP to 14 percent by 1999. In this connection, we welcome the recent tax policy measures and the efforts to broaden the tax base and simplify the tax system. On the expenditure side, the reorientation of outlays toward essential social services and infrastructure investment is most welcome and important for the sustainability of and public support for the reform effort.

While substantial progress has been made, the banking sector remains small and the level of intermediation remains low. The NBG's banking supervision function should be strengthened and its independence enhanced. We also urge the authorities to complete reforms in the financial sector, including the closure of noncertified banks and the restructuring of the former state banks. Private ownership and management of commercial banks, and entry of reputable foreign banks should be encouraged to foster competition.

While still on the banking sector, it should be noted that despite the sharp fall in nonperforming loans (from about 30 percent of total loans in 1995 to less than 7 percent at end 1996), the spread between the lending and deposit rates remained very high at about 40 percentage points. Moreover, the composition of broad money shifted in favor of currency in circulation as shown on page 15, despite the positive real rates on deposits during 1996. I would be interested in further staff views on this issue.

As for public enterprises, we commend the authorities' plan to complete the second wave of privatization of "non-strategic" medium- and large-scale enterprises by the end of this year, and as much as possible to reduce the list of "strategic" enterprises. However, the status and the list of strategic enterprises need to be clarified, and the role of the state in enterprise governance brought in line with that in other market economies. The authorities are also encouraged to foster the development of capital markets to facilitate the resale of shares by small owners lacking the necessary capital and management skills.

Finally, some comments on the medium-term scenario. The staff's projections on page 32 show that exports to GDP ratio remains low at about 11 percent through year 2006, while imports to GDP ratio declines substantially from about 19 percent in 1996 to 11 percent by 2006. Does this imply that despite Georgia's strong adjustment and good record of structural reforms the economy will remain relatively closed to the outside world, and is this consistent for a developing country that is slated to embark on continued rapid growth? To sustain real GDP growth at 8–10 percent, large imports of intermediate and capital goods, and significant improvement in infrastructure will be needed. Having said that, I question the merits of a low current account deficit in the medium term when Georgia needs to stay on a high growth trajectory, and I would be interested in staff views regarding the potential for higher export growth or slower pace of narrowing the current account deficit in the context of sustainable debt levels. Larger direct foreign investment flows would permit modest current accounts deficits without excessive increases in external indebtedness. The staff comments would be welcome.

In conclusion, I wish again to commend the authorities for the success of their stabilization program. We support the proposed decisions and wish the authorities continued success.

Mr. Fayolle made the following statement:

I commend the staff for an excellent and condensed set of papers. I would like also to join the other speakers in commending the Georgian authorities for their impressive performance under a demanding ESAF arrangement. Indeed, the adequate and courageous policy implemented in Georgia has already been fruitful, with 10 percent growth in 1996 and sharply reduced inflation.

The message we should convey to the authorities is to pursue in this path and resist any pressures in the direction of weakening macroeconomic policies, especially in the fiscal area.

I share much of what has been said on concerns about fiscal policy, especially those expressed by Messrs. Esdar, Andersen, and Vernikov. I welcome the measures taken to increase the revenue to GDP ratio and the revenue-to-expenditure ratio in 1996, but I am concerned about the slippages in the second half of the year and about what I perceived in the recent staff supplement as a likely new slippage for the revenue performance in the first quarter of 1997. Indeed, the revenue objective for 1997 is very ambitious and, therefore, I share Messrs. Esdar's and Andersen's concern that the authorities should be cautious about raising excise taxes before ensuring that the revenue objective is right on track.

I have another concern related to the increase in domestic arrears in 1996, and I wonder whether it would have been appropriate in the case of Georgia to have a performance criterion related to the nonaccumulation of domestic arrears in 1997.

In any case, I hope that the authorities will not only look in the direction of reducing expenditures in the case of any revenue shortfall from the level projected in the program, but also offsetting this shortfall with new revenue measures as indicated in the staff appraisal.

On monetary and exchange rate policies, I agree with the recommendation made by the staff, but I think that this issue should be kept under close scrutiny since the very low level of reserves and the size of the current account deficit are a matter of concern. I hope that the increased confidence in the currency and the banking system will lead to a substantial decrease in the currency held outside banks.

Finally, I welcome progress in the external debt issue and in particular the agreement in principle with the European Union to provide exceptional financial assistance to Georgia.

The staff representative from the European II Department made the following statement:

The first and foremost issue is the authorities' fiscal performance, which will remain at the core of our attention for the next few years in Georgia. Directors have noted that revenue performance, despite improvement, remains low and this is, in fact, the case. The authorities at this point are convinced that they have reached a stage where they can make a determined effort in 1997. In fact, as we have tried to point out in the staff statement issued before the Board meeting, in the first two months of the year—despite the seasonal fluctuation due to the Christmas holidays—revenues were in real terms twice as much as last year. Nevertheless, the staff expects a shortfall, unfortunately, against the ambitious program targets for the first quarter.

A number of Directors have mentioned that perhaps the staff should consider focusing more on revenue measures. Unfortunately, there are no easy ways to increase revenues in Georgia. The main focus in generating more revenues has been—and will continue to be—on improving tax and customs administration for some time to come. The Fund has provided a significant amount of technical assistance in this area—which is beginning to have an impact—and the authorities are extremely focused on this issue at this time. The President of Georgia is holding bimonthly meetings on revenue performance, and he has established more ambitious targets for the government and regions to meet than those agreed under the Fund-supported program. While the more ambitious targets may prove to be somewhat optimistic, the program targets could be within reach with sufficient political effort.

The issue of reductions in the excise tax rates, which a number of Directors have mentioned, was difficult because the staff could not find any evidence of a case where a reduction in the rate helped reduce tax evasion. However, the authorities were in favor of such a reduction, noting that it would give them the moral authority to enforce the tax laws. The staff acquiesced because it would be a low-cost experiment, given that the amount of excise tax collected in 1996 was low—less than 15 million lari. The actual

losses might be small, if any. After two months, there is no evidence that reduction in excise rates has generated more resources. The collection of excise taxes has improved, but one could easily attribute this to better tax administration and the increased rate on petroleum. An evaluation of this experiment would need to await a further passage of time.

There is not much scope for introducing new revenue measures that would have much of an impact in the short run. However, that does not mean that exemptions cannot be rationalized in time for next year's budget. Mr. Vernikov mentioned, for example, the rationalization of the value-added tax rates. That rate has already been increased to 20 percent in the context of the 1997 budget. There had been only one 10 percent lower rate for bread and flour, which was subsequently increased to 20 percent. As a result, the rate is currently uniform, but there are exemptions and one could argue that such exemptions are perhaps still too many. At the end of the day, the focus would need to remain on plugging up the leakages in the tax system, and improved tax and customs administration would have to play the central role in improving revenue performance.

Expenditures are at a more tolerable level now than they were a couple of years ago because the revenue situation has improved. There is a clear effort on the part of the authorities to shift resources to high priority areas—especially health care. Health expenditures have increased in real terms, by a substantial amount, despite the removal of about 120,000 people from the budget and their transfer to the private sector. There is an effort, together with the World Bank—as Directors had asked—to rationalize the efficiency of health expenditures. In fact, in 1997 the government intends to monitor closely these expenditures so as to ensure that government obligations remain in line with the provisions approved in the budget, but also to ensure that these obligations are paid on time.

While capital expenditure has not been given high priority due to resource constraint, it is most urgently needed. Unfortunately the trade-offs are not very pleasant. However, not all capital expenditure is presented the budget that was outlined in the staff report, partly because the staff did not want to crowd out the picture by large numbers. For example, there is a substantial amount of investment in the energy sector that is not reflected in the budget because it is not solely going through the government.

On the question of whether a performance criterion on the nonaccumulation or reduction in the accumulation of arrears would be feasible, the staff believes that, at this stage, the measure would not be appropriate partly because the authorities do not have any meaningful record for expenditures on a commitment basis. What is viewed as expenditure arrears in the program is what the Ministry of Finance is aware of in terms of expenditure arrears. Now, as Parliament becomes increasingly influential, the quarterly review of fiscal performance by the government and by the parliament is intended to introduce more discipline in the system. If the revenue performance falls below the targets, then the parliament, in discussions with the government, will decide which expenditures to reduce and, thus, reduce the legal authority

of the government to incur obligations that could not be paid on time. Although a treasury is being developed, it is unlikely that it could collect information on expenditures on a commitment basis before end-1998. The Fiscal Affairs Department is providing technical assistance to that end. Under the circumstances, the indicative target is perhaps as much as can be expected at this stage.

Several Directors have questioned the wisdom of the central bank providing credit to the government and then trying to sterilize part of that in order to stabilize the exchange rate. Clearly, that practice is unsustainable, especially since the reserve position is not strong; the authorities must exercise caution. However, Georgia had experienced hyperinflation, and the exchange rate, to the extent that it remains stable, plays a critical role supporting the public's confidence in the reform package. As a result, the authorities are reluctant to accept any depreciation of the lari to the extent that it can be avoided. Having said that, however, the underlying fiscal policy is not sufficiently strong to support this sort of activity. So the authorities' intention is to buy time for the fiscal revenue package to begin to work and for revenues to increase so that the reliance on the central bank credit would be reduced over time.

The authorities are planning to issue Treasury bills starting in the second half of the year, and multilateral technical assistance is being provided in this area. However, for a government that has had a difficult time paying its bills, it is questionable that a significant amount of resources can be raised immediately. Initially, this will be more of a market test; if it proves successful, then perhaps in 1998 more financing could come from the sale of Treasury bills. However, it is also important that the authorities do not divert the banking system away from providing credit to the economy and toward the more secure practice of simply buying Treasury bills.

On monetary policy, a number of questions have been raised. The issuance of guarantees by the National Bank of Georgia (NBG) to wheat importers in 1996 was unfortunate—a view shared by the authorities, including the President of the NBG. However, there are lingering problems associated with the independence of the NBG that weakens its position. For example, the law outlining the independence of the central bank has existed for a year and a half, but the bank's board has not yet been appointed. The temporary status of the President of the NBG weakens his ability to resist pressures such as the pressure to provide guarantees to wheat importers. The authorities are fully aware of this problem and the President of the Parliament, during his visit last week with the Managing Director, stated that the central bank's board would be appointed soon. The staff would continue to monitor the situation and welcomes the authorities' commitment, outlined in the statement of economic policies, that they would refrain from providing any further guarantees in the coming year.

On the structural side, the condition of the Agrobank is quite difficult; in fact, it could easily be debated whether this bank should be closed, particularly since credit unions would provide some more expertise, especially

in the area of agriculture. The authorities, however, are not prepared to close the bank at this stage, because it is the bank with the largest number of branches throughout the country. Although some of these branches are not in operation, they are concerned that closure of this bank would send a wrong signal to the population and undermine confidence in the stabilization program. So they have, as a prior action, put the bank under temporary administration and hope that conditions will improve, which is doubtful. The issue of what to do with the Agrobank may come back as part of a package later on.

With respect to the question regarding the appropriate action dealing with nonlicensed banks, the authorities expressed the hope that they would merge with some of the larger banks—especially since it is generally agreed that, at 62, the number of banks is too large for Georgia. The banking supervision department of the NBG has improved tremendously. In fact, it is one of the more impressive developments in the banking sector area. There is now an on-site inspection of a good number of banks. The process of licensing will hopefully be completed soon and some of these banks may soon have to start the liquidation process. As was mentioned, two of the larger banks are doing well, while the Agrobank remains a problem.

With respect to Mr. Iradian's questions on the high spread between deposit and lending rates and the shift in the composition of broad money from deposits to currency in circulation, one can notice a gradual change over time, although these trends are related to the financial position of banks and public confidence in them. While the change is small, the amount of currency outside the banking system is declining. A concerted effort is under way aimed at improving confidence in the banking system. Banking sector reform, which is perhaps the most important, is being widely publicized in Georgia. Also, there has been a clear effort to keep the tax authority out of the banking system, because the public is wary of depositing money in banks because they view banks as an extension of the tax administration. While the appropriateness of such a measure could be debated in principle, in the case of Georgia it was not a bad idea. Together with other measures—such as the reduction of the profit tax for banks and encouraging the participation of foreign partners in order to boost banks' capital base—the banking system is developing gradually. New banks, in effect, are being created and older banks are losing market share, but, as in other transition economies, that process will take a few years to develop fully.

A Fiscal Affairs Department team will be visiting Georgia shortly to provide technical assistance on the types of fiscal federalism the authorities could consider. The authorities wish to review the revenue sharing mechanism between republican and local government and, at the same time, the expenditure responsibilities that could be transferred to the local governments. However, there is a debate within the parliament over the degree of political independence that should be granted to the provinces.

On the privatization, the authorities intend to reduce the list of strategic enterprises, and discussions with the World Bank are ongoing. The Bank has

noted that such a measure will be an element of the conditionality under the second Structural Adjustment Credit currently under negotiation.

On the staff's balance of payments projections, it is difficult to say whether the staff's foreign direct investment projections are too optimistic. While there has been much interest expressed about foreign investment, the available information shows little actual investment in Georgia, and the staff's medium-term scenario, which is suitably cautious, should be considered in that context. However, if Mr. Iradian were correct and there is a substantial pick-up in foreign direct investment, then the potential for imports will be different. The staff has felt that it is not prudent for Georgia, with such a massive external debt that is still unresolved, to aim at large current account deficits at this stage. There are large financing gaps that have to be financed for the next few years and certainly the amount of resources that the Fund and the Bank can provide are limited. Nevertheless, the situation is improving and the key factor will be to have more fiscal adjustment over time.

Mr. Saha made the following statement:

I would like to commend the Georgian authorities for the continued efforts made in the recent two years to improve macroeconomic conditions in Georgia and advance far-reaching structural reforms. As a result, output has recovered markedly, inflation has decelerated sharply and the external sector position continues to improve, with increased confidence in foreign investment.

Nevertheless, the Georgian economy remains fragile, as illustrated by the staff medium-term scenarios. In this connection, I broadly support the policy measures contained in the 1997 program to address the weaknesses in the public finances, deepen the structural reforms, and consolidate the gains achieved so far. I welcome the staff buff, that all prior actions under the program are met, and that the 1997 budget approved by Parliament was in line with the program expectations. These are good indications that the adjustment process is continuing in Georgia.

I broadly share the staff's analysis and policy recommendations. I also support most comments made by previous speakers. I shall, therefore, limit my remarks to the fiscal policy and to structural reforms.

On fiscal policy, Georgia is confronted with a relatively low budgetary revenue, which, in 1996, stood at about 8 percent of GDP, or 63 percent of current expenditures. In this regard, in order to avoid further revenue shortfalls and meet the program's overall deficit target in 1997, the authorities should implement the comprehensive measures envisaged under the program to strengthen tax and customs administrations, resist pressures for tax exemptions, and intensify their efforts to collect tax arrears. While supporting the recent tax changes to improve efficiency in the tax system, I would encourage the authorities to monitor revenue performance closely in order to take corrective measures if these tax changes cause revenue shortfall. In the same vein, the authorities should take the necessary steps to ensure that the new tax code will be enacted by June 1997. I find the contribution of the

customs duties to total revenue in 1995 and 1996 very low (2.4 and 4.3 percent respectively), and would like to ask the staff whether consideration should not be given for some moderate increases in import tariff rates.

On the expenditure side, I welcome the efforts made to restructure expenditures in favor of high priority sectors, with more emphasis on the pursuit of prudent wage policy, and the curtailment of subsidies and transfers. I would, however, encourage the authorities to contain the so-called other current, unclassified and extra budgetary expenditures, which continue to grow faster. In this connection, I urge the authorities to adopt a comprehensive nomenclature that will enhance budgetary transparency. I also agree with previous speakers that the building of a Treasury system is critical to control expenditures, and welcome the authorities' timetable to include all budgetary accounts and special state funds into the Treasury system. I note that the capital expenditure/GDP ratio is projected to decline in 1997, and would caution against further reduction in capital expenditure.

On structural reforms, I commend the authorities for swift progress made in several fronts, mainly the privatization of the small and medium-sized public enterprises, the bank certification program, price and trade liberalization. More needs, however, to be done, to complete the rationalization of the civil service, address the problems of the former state banks, and restructure the large public enterprises. I welcome additional comments provided by the staff on the authorities ongoing restructuring efforts. However, I would encourage to adopt a more comprehensive action plan regarding these banks and public enterprises.

Finally, I commend the Fund and other institutions for technical assistance provided to Georgia. I encourage them to help address the remaining weaknesses in the statistical data. I support the observation made by Mr. Coumbis that the authorities should strengthen their efforts in this sector.

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

Mr. Ogushi made the following statement:

At the outset, I would like to join other speakers in commending the authorities for their efforts toward implementing economic reform, which have led to the remarkable result of strong growth with rapidly falling inflation. Against this background, I have no problem in supporting the approval of a second annual arrangement under the ESAF.

As to the challenges ahead that the authorities will need to deal with, I broadly agree with the thrust of the staff appraisal.

One of the most important tasks that the authorities should continue to tackle is to strengthen the fiscal position. This is a critical task, especially now that the authorities are allocating more funds to policy fields such as education and health, a policy stance I commend. In this connection, I urge the

authorities to step up their efforts to increase tax collection. In this context, I welcome the tax policy reform that has recently been introduced, although I am not fully convinced of the possibility of increasing tax revenue after cutting certain excise tax rates. Close monitoring of the trend of tax collection will be needed. Steady implementation of the envisaged tax measures, including the adoption of the Tax Code should be given high priority.

With these remarks, I wish the authorities well.

Mr. Issaev made the following statement:

Since I am in broad agreement with the thrust of the staff appraisal and share many of the views of previous speakers, I will be brief and limit myself to a few points for emphasis.

We commend the Georgian authorities for the remarkable progress made so far in macroeconomic stabilization and for accepting the obligations of Article VIII. It is encouraging to see a strong recovery in output growth, a significant reduction in the inflation rate, and the strengthening of the international reserve position. Progress in structural reform was also impressive. However, despite these achievements, the weakness of the public finances remains a difficult challenge for the authorities. Therefore, the government should press ahead with tax reform. Strengthening of the tax and customs administration with enactment of a new Tax Code and a new Customs Code should be a priority for the authorities in the period ahead. The measures to raise revenues should be supplemented by efforts to improve expenditure control. Prioritization of expenditures also seems to be necessary. All improvements on the stabilization front are not secured as long as the authorities do not restore the health of the banking system and restructure the energy sector.

We welcome the progress achieved in normalizing relations with external creditors. Nevertheless, we have to formally attract the attention of the Board to Georgia's substantial arrears accumulated over the time on the in-kind settlements agreed upon in the Intergovernmental Agreement between Turkmenistan and the Republic of Georgia on the payment of debts for deliveries of gas from Turkmenistan signed on March 3, 1996. In the Statement of Economic and Financial Policies for 1997, Paragraph 27, it is stated that in regard to arrears in-kind accumulated prior to mid-1995 on account of shipments for deliveries of gas from Turkmenistan, Georgia has shipped already the equivalent of $15 million, and intend to settle the remaining $6 million by March 1, 1997. However, we have been informed by the Turkmen authorities that despite all measures taken by Turkmenistan and a number of clarifications regarding gas supply to Georgia this matter has not been arranged until the present time. In this connection, we would urge the Georgian authorities to clear these arrears.

With these remarks we support the proposed decision and wish the authorities well for the job that still lies ahead.

Mr. Borpujari made the following statement:

Georgia's economic performance under the first annual ESAF arrangement has been most encouraging. Growth accelerated, inflation decelerated and important progress was made in macro stabilization and structural reform. The progress made in reforming the banking sector and in privatizing agricultural land is especially noteworthy.

These achievements notwithstanding, the Georgian economy remains fragile and further efforts are clearly needed. In the immediate term, continued restraint in fiscal and monetary policies is a precondition for ensuring the maintenance of Georgia's good performance. However, the success of these policies hinges importantly on continued vigilance in the implementation of structural reforms, strengthening of measures relating to privatization, and building the administrative capacity of government. Invigorating the private sector should be given the greatest attention.

Despite improved performance in the fiscal area, there is little room to maneuver. As Mr. Vernikov, among others, has noted, the scope for further compression of expenditures is limited. At the same time, revenue performance, though improving, remains below program targets. Therefore, the immediate priority is to address the revenue shortfalls. The measures aimed at broadening the tax base and bolstering the tax collection effort are thus steps in the right direction. In that connection, I wish to stress that an early and full implementation of the several accounting and administrative improvements will be crucial for lasting improvements in the revenue performance.

Achieving the programmed increase in private investment also depends on accelerating structural reform. In particular, determined efforts to restructure and privatize public sector enterprises remain a priority. Of equal importance is the achievement, in a timely manner, of further progress in urban and industrial land reform. In addition, further progress in strengthening the banking sector is essential for enhancing confidence and mobilizing savings.

Finally, I join other Directors in commending the staff for the excellent presentation of the issues.

With these remarks, I support the proposed decision and wish the authorities further success in their economic management.

Mr. Phan made the following statement:

I would like to commend the Georgian authorities for their significant progress made under the first annual ESAF arrangement. As pointed out in the staff report, real GDP growth is now estimated at over 10 percent, while the updated paper of the staff shows that the inflation rate for the year ending in February was 12 percent, compared to 14 percent during 1996 and about 57 percent in 1995.

Structural reforms in 1996 were implemented in line with program expectations. Georgia is also highly commended for making significant progress in normalizing relations with external creditors during 1996 and January 1997.

As noted in the staff report, the banking sector reform has made steady progress, thereby increasing public confidence in the banking system. However, the authorities are urged to press vigorously ahead with reforms in this sector, especially the establishment of a sound banking system to promote intermediation and private sector activity.

I am also pleased to hear from the staff that restructuring programs have been agreed with the former state banks and the Agrobank has been placed under new management as scheduled.

Notwithstanding significant headway in all domains, the authorities should pay due attention to the fiscal policy stance since it was looser in 1996 than envisaged under the program. I would like, by the way, to recall that at the Board discussion on September 23, 1996, Directors underscored the urgent need to strengthen public finances; in particular, to improve significantly tax revenue performance in order to avoid compromising stabilization and growth prospects over the medium term.

Enormous efforts are called for to meet the projected highly improved revenue performance in 1997, if the authorities are to meet additional expenditure requirements, especially to address the concern about inadequate resources for social spending and infrastructure development.

As applicable to every country in transition, structural reforms play a decisive role in sustaining macroeconomic development. It is, therefore, quite interesting to acknowledge the authorities' commitment to accelerating the implementation of structural reforms, especially the restructuring of the energy sector during 1997.

In the meantime, they are urged to make reforms of the legal framework for the privatization of urban and industrial land in order to create an environment conducive to investment.

In conclusion, I would like to express full support for the proposed decisions and wish the Georgian authorities every success in their endeavor.

Ms. Brettschneider made the following statement:

We agree with other speakers that Georgia has put in a very strong performance in the midst of difficult conditions during its first annual ESAF arrangement. We also endorse the staff's analysis and recommendations laid out in the staff report and accompanying documents, which, as always with this team, we found to be of the highest quality.

My colleagues have already raised the key issues needing attention, and the length of today's Board agenda is further motivation to be brief. Let me therefore underscore just a few critical points that my authorities feel should be given the highest priority under the second annual arrangement.

The 1997 program's primary emphasis on strengthening further public finances is fitting. The goal of increasing revenues by 2.5 percent of GDP (with a corresponding reduction in the fiscal deficit from 5.8 percent to 3.5 percent on a commitment basis) is highly laudable. The target is ambitious, but feasible if Georgia can maintain its strong commitment to the many politically tough and sometimes technically challenging reforms outlined in the program document. In particular, the eight measures described in the 1997 program on tax administration will be vital if Georgia is to lock in stabilization gains. Enactment of the new Tax and Customs Codes by mid-year will not only be crucial in strengthening public finances, but will also sharply improve the investment climate, paving the way for future growth.

On monetary and exchange rate policy, we have little to add to the staff's analysis, and support their recommendations without repeating the arguments.

A vital issue which we thought should have been addressed more directly in the staff report is the need to tackle endemic transparency and corruption problems in Georgia. In areas as diverse as tax and energy, the same issues of corruption are coming up. Committing to the politically painful but much needed anti-corruption reforms will not only be of first order importance for Georgia's success, but will facilitate the deployment of technical assistance resources from bilateral donors as well. I know my own authorities have questioned the utility of providing technical assistance in the tax area, for instance, due to the seriousness of these concerns. This will be an on-going concern in donor assistance decisions.

Other areas where particular attention should be paid are accelerating progress on agricultural land privatization, banking reform, and legal reform, including development of a legal framework for privatization of urban and industrial land, medium- and large-scale privatization and energy sector reform. It looks like very little progress has been made in recent months on medium- and large-scale privatization in particular, with more talk about restructuring rather than up-front privatization. Our view, in most cases, is that private owners are better placed to make restructuring decisions than are governments. Further delays send the wrong signals to markets about the government's commitment to reform.

We welcome the progress Georgia has made over the past year to reach agreements with bilateral creditors that are in line with program assumptions. While we have heard some positive soundings with respect to a prospective agreement with the EU, details are still murky. We would be interested in anything more the staff or Mr. Yakusha has to offer, particularly whether we can be assured that the agreement is in line with Georgia's capacity to repay as assumed under the program.

Georgia's future prosperity will be intricately entwined with other economies in the Caucuses and with the development of Central Asia and the Caspian. Energy sector reform and improvements in the transportation infrastructure will be vital for Georgia to play its proper role in the development of the region.

Finally, I do not support Mr. Saha's suggestion to raise import tariff rates as an alternative source of revenue. It would be most unfortunate if Georgia fell into the trap of over-reliance on trade taxes, which have been proven to have a clear and detrimental impact on competition and growth prospects elsewhere.

Mr. Huang made the following statement:

I join others in complimenting the staff for providing us such excellent papers. As I am in broad agreement with them, I can support the proposed decision with following comments for emphasis.

The authorities are commended for their remarkable progress on stabilization and structural reform. It is particularly praiseworthy that annual inflation has come down from hyperinflationary levels to 14 percent within the last two years; economic activity has picked up strongly; the external current account has improved; and structural reforms have been implemented in line with program expectations. The authorities are also congratulated on becoming an Article VIII member.

Nevertheless, the authorities still face daunting challenges ahead, especially as the public finances remain weak, and if not significantly improved in a timely manner, will threaten the prospect for sustainable growth over the medium term. In this regard, it is welcome that the authorities have given top priority under the medium term program to raising government revenue to cover current expenditure and allow a much needed increase in public investment. The authorities are encouraged, built upon the improvements achieved so far, to further strengthen tax and customs administration. In order to reinforce the legal basis for tax administration, the timely adoption of the Tax Code is of utmost importance.

On the monetary side, we concur with the staff that the pursuit of a prudent monetary policy is essential for the achievement of the program objectives. One of key elements in keeping the prudent stance of monetary policy should be to gradually reduce bank financing of budget deficits and develop noninflationary financing means. In our last discussions, noting that the fiscal deficit financing fully depends on the external and banking sources without any nonbank financing, we underscored the importance of accelerating the development of the treasury bill market to secure nonbank financing for the budget deficit. In this context, we welcome the planned introduction of Treasury bills by mid year. The authorities are encouraged to strengthen their efforts toward the early establishment of a Treasury bill market and the adoption of indirect monetary management.

As the staff stressed, Georgia has made significant headway toward normalizing relations with external creditors. In this respect, I would like to point out that China is prepared to conduct negotiations with the Georgian government on the rescheduling of the debt and hopes to reach an agreement at an early date.

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

Mr. Watal made the following statement:

Our chair is in agreement with the assessment and recommendations made by the staff for a second annual arrangement under ESAF. The program and stabilization results are indeed impressive and we wish to commend the authorities for the progress that has been made since the last review.

It is heartening to note that economic activity has picked up and most of the key macroeconomic indicators show that the reforms are in line with expectations. Inflation has been within target bounds at 12 percent, the external current account has improved, trade is expanding, the exchange rates have been broadly stable and the real GDP growth crossed 10 percent in the year 1996.

In the appraisal we find that the issue of fragile public finances and the lacunae in fiscal adjustment have again been brought into focus and the staff has observed that the weakness in the fiscal program, especially the unsatisfactory efforts at raising revenue, could adversely affect the gains of stabilization. This is at variance with the confidence of the authorities who are, no doubt, committed to the compliance with program targets for 1997 namely reducing the public sector deficit, elimination of arrears and improvement of revenue performance. While the overall deficit is targeted to be reduced from 4.5 percent of GDP in 1996 to 2.8 percent of GDP in 1997 and an impressive program has been worked out for 1997 to improve revenue performance so the total revenue is to touch 10.7 percent of GDP the report has mentioned a crucial caveat that in case of a shortfall the authorities would reduce expenditure accordingly. From this one does get an impression that the authorities may not be fully confident about achieving the projected targets on this front. In the event of a worst case scenario any compression of expenditures could fall on the soft sectors like health and education. The staff may wish to comment on this.

There is an observation on the burden of debt. Georgia had accumulated heavy short term debt during the trying years 1991–94. The debt service liabilities had suddenly mounted. The repayments have no doubt been rescheduled with major bilateral creditors and this has mitigated the immediate burden of heavy debt servicing. Staff has estimated that "despite considerable risks" debt service is projected to peak at 22 percent of exports of goods and non factor services in 2000 and then decline to below 18 percent by 2006. On the basis of these projections it has been suggested that Georgia's capacity to repay the fund would improve. Does this projections convey an underlying

sense of concern? Evidently, the answer to medium term sustain ability would eventually lie in the internal progress in areas such as taxation reform, strengthening of the financial sector and augmentation in domestic savings. Could the staff spell out these risks more explicitly.

In conclusion, our chair would congratulate the staff for the cogent staff report and the useful background papers and we also convey our best wishes to the authorities for all their future endeavors.

The staff representative from the European II Department noted that the effective customs rate was low because much of Georgian imports was humanitarian and food assistance, and therefore tax exempt. Also, the customs agreement with other CIS countries exempted from import taxes imports from those countries. Having said that, customs administration in Georgia was not satisfactory, although the situation had been improving recently. The new head of the customs authority seemed dynamic and competent, and the World Bank had been providing technical assistance aimed at improving customs administration.

The staff considered that, despite the pressing revenue needs, it would not be prudent for the authorities to raise trade tariffs, the staff representative continued. Such a move would deter the improvement of industrial competitiveness, which was urgently needed. However, a vocal group of industrialists had called for protection of domestic activities. The current tariff system—despite the unfortunate move from a uniform rate to a dual rate in 1997—would help promote efficiency in the economy.

The staff agreed that more transparency in the government's expenditure classifications in the budget was needed, the staff representative said. The government had been criticized in parliament for placing about half of its expenditures under "other items" in the 1997 budget.

On the issue of reform of large-scale enterprises, the staff was somewhat concerned that, although it was still too early to be sure, there might be an underlying shift in thinking in Georgia away from the need for more privatization, the staff representative remarked. The authorities were considering reintroducing the Ministry of Industry, which would likely be an opponent of further significant reform. The World Bank was working on the privatization of medium- and large-scale industries, but there had been little progress recently, owing, in part, to the authorities' insistence on unreasonably high minimum prices in the auctions.

Transparency and corruption were serious issues in Georgia, particularly as the economy progressed and there were more resources that could be diverted to nontransparent ends, the staff representative noted. The president was concerned and had established anticorruption committees in almost every spending unit. Also, the parliament was increasing its oversight of such activities and demanding detailed reports from spending units. While corruption and transparency would remain important concerns in Georgia, the development of a treasury, the increased oversight of the budget by the parliament, and improvements in tax administration would improve the situation.

The staff would welcome an early resolution of Georgia's external payments problems, the staff representative stated. The staff had discouraged the Georgian and Turkmen authorities from utilizing in-kind payment arrangements to resolve outstanding payments

because such arrangements were not transparent and difficult to monitor. However, the agreed-upon barter arrangements had led to a discrepancy over how much was owed to Turkmenistan. The Georgian authorities had accepted that they had fallen behind in some of their payments, but they had hoped to reconcile the exact amount owed. Moreover, the Georgian authorities recognized the importance of maintaining both good relations with Turkmenistan and a good payments record. Regarding debt service obligations in cash—performance criteria under the Fund-supported program—the Georgian authorities had paid about $32 million to Turkmenistan, in line with their bilateral agreement. The staff had been informed recently that the Georgian authorities had received a payment extension from the Turkmen Ministry of Trade. The staff would continue to encourage the Georgian authorities to observe all payment deadlines.

Mr. Saha said that he had raised the issue of customs duties because he considered that the contribution of customs duties to overall revenue in 1995–96 had been low. Also, given the low revenue to GDP ratio, an improvement in revenue performance was essential, especially to improve the country's infrastructure.

Mr. Issaev remarked that the Turkmen authorities had informed him that the discrepancy between the Georgian and Turkmen figures on outstanding payments owed to Turkmenistan was $9 million.

The Deputy Director of the Policy Development and Review Department said that the use of a structural benchmark in Fund-supported programs for a floor for health expenditures was not common. While it was a manifestation of the increasing interest in social sector issues, it was too early to conclude that such a benchmark would become a feature of Fund conditionality.

Mr. Yakusha made the following concluding statement:

> Let me reiterate the intent of my authorities to remain in close dialogue with the Fund and assure you that all suggestions and concerns expressed by the Executive Directors will be examined carefully by the authorities, with a view to learning from Fund advice and the experience of this Board.
>
> Let me also mention two issues that may not have been covered much and let me try to address the concern expressed by the U.S. chair on projections and capacity to repay the Fund.
>
> There is a bright side to the prospects for the continuation of successful reform—the positive cooperation between the executive and legislative branches of the Georgian government. Indeed, the Chairman of the Parliament, who visited the Fund last week, expressed his full support for the authorities' cooperation with the Fund.
>
> Georgia still faces an uneasy political environment. Certain issues have not been settled with respect to the Abkhaz secessionist movement, and that, alongside the weak fiscal performance, is one of the factors constraining inflows of foreign direct investment. My Georgian authorities are doing their best to address both these challenges.

On behalf of my authorities, let me express sincere gratitude to the representatives of various countries that have provided Georgia with financial assistance and debt restructuring, and let me emphasize that my Georgian authorities would expect wealthy nations to continue to support financially the current ESAF arrangement.

Unfortunately, Georgia is still dependent on external official financing. Hopefully, once political issues are settled, Georgia would be able to increase significantly exports and to get enough foreign direct investment to have a more sustainable external position.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for the continuing success in the implementation of Georgia's stabilization and reform program. Directors highlighted the sharp decline in inflation, the strong recovery of output, the stability of the exchange rate, a narrowing current account deficit, and a strengthening of the international reserve position. Directors also praised the acceleration of structural reforms in many important areas. Directors urged the authorities to persist in their efforts to transform Georgia into a full market economy.

Directors emphasized that strengthening the public finances would play a central role in the authorities' adjustment program. Notwithstanding the progress obtained thus far, tax revenue remained at a low level. Directors therefore underscored the need to improve revenue mobilization to attain the fiscal targets for 1997. Also, Directors called for further efforts to increase tax collection by broadening the tax base and strengthening tax and customs administration. In that regard, some Directors were skeptical about the ability of the planned reductions in excise taxes to reduce tax evasion and thereby improve revenue performance; they therefore called for the identification of additional revenue-raising measures. The adoption of the new Tax and Customs Codes in mid-1997 should improve the transparency of the tax system and provide for a more uniform tax structure. Directors also urged the authorities to resist pressures to reintroduce exemptions.

A number of Directors expressed concern about the compression in spending in the past couple of years, especially in the social sectors and for infrastructure. They therefore welcomed the priority accorded to primary education and basic health in the 1997 budget. In view of the already compressed spending, which left little room for further cuts, some Directors questioned whether the authorities' intention to reduce expenditure authorizations further for the remainder of 1997 in case of a revenue shortfall was appropriate. Directors also encouraged the authorities to step up efforts to develop an effective Treasury to improve fiscal transparency.

Directors urged the authorities to avoid monetary financing of the fiscal deficit and to eliminate domestic arrears. In that context, they welcomed the authorities' decision to introduce Treasury bills in 1997 and their efforts to develop a government securities market.

Directors endorsed the authorities' monetary and exchange rate policies, which had been key to the achievement of program targets. They welcomed the signs of increased real demand for lari and noted that such confidence needed to be nurtured by a strengthening of fiscal policy. A number of Directors expressed concern about the issuance of guarantees by the National Bank of Georgia to wheat importers in 1996, and urged the National Bank of Georgia to refrain from providing such guarantees in the future.

Directors stressed the importance of pressing ahead with further structural reforms, particularly reducing the number of budgetary employees, accelerating privatization—with a reduction in the number of strategic enterprises—restructuring of the energy sector, the adoption of new legislation, and the enforcement of existing laws and regulations. Directors also encouraged the authorities to make further progress in banking sector reform, especially in restructuring the former state banks, closure of noncertified banks, and building up a supervisory capacity at the central bank. They also urged the authorities to press ahead with agriculture and land reforms. Such measures, together with further progress in macroeconomic stability, should enhance the climate for foreign investment, which should play a crucial role in the transition process.

Directors welcomed the progress in normalizing relations with external creditors, and encouraged the authorities to expedite debt-rescheduling negotiations. Directors remarked that Georgia's adjustment and reform efforts would continue to require external assistance.

Directors noted that a substantial amount of technical assistance had been provided to Georgia by the Fund, and urged the authorities to make efforts to improve their absorption capacity.

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

The Executive Board took the following the decision:

1. Georgia has requested the second annual arrangement under the Enhanced Structural Adjustment Facility.

2. The Fund has appraised the progress of Georgia in implementing economic policies and achieving the objectives of the program supported by the first annual arrangement, and notes the updated policy framework paper set forth in EBD/97/20.

3. The Fund approves the second annual arrangement set forth in EBS/97/29, Supplement 1.

Decision No. 11463-(97/26), adopted
March 21, 1997

6. OMAN—1996 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1996 Article IV consultation with Oman (SM/97/57, 2/24/97). They also had before them a background paper on selected issues in Oman (SM/97/78, 3/10/97) and a statistical appendix (SM/97/65, 2/27/97).

Mr. Shaalan made the following statement:

First, I wish to express the Omani authorities' appreciation of the staff's analysis and appraisal. They are grateful for the extremely useful report and background paper on the Omani economy and for the valuable advice contained therein.

For the past several years Oman's economic growth was sustained at about six percent annually and inflationary pressures were practically nonexistent. Private sector participation in the economy rose despite the contractionary effects of declining real oil prices. This was achieved in part through a supportive expansionary fiscal policy that sought to shield the economy from terms of trade shocks. The fiscal stance was mirrored in relatively high current account deficits over the period and a drawdown of foreign investments and reserves of the State General Reserve Fund (SGRF).

As foreshadowed in last year's Article IV consultation, the Omani authorities, in late 1995, fully realized that past expansionary policies, while successful, could not be sustained. In the framework of the First Five-Year Plan (FFYP) covering the period 1996-2000, a far-reaching and comprehensive strategy that represented a fundamental departure from past policies was formulated. The strategy aimed at boosting national savings and investment to assure sustained future output and employment growth while diversifying the economy away from its dependence on the oil sector.

The cornerstone of this initiative was centered around strengthening the fiscal stance over the medium term with the aim not only of eliminating the budget deficit by the year 2000, but equally to effecting important changes in the composition of government expenditures and revenues to promote public saving and to build up the reserves of the SGRF. The medium term fiscal consolidation plan is expected to reduce the role of fiscal policy in supporting economic activity and to enhance the investment climate to make it more conducive to private sector activity and less dependent on government outlays.

The energized initiative was launched in 1996, and the results of the first budget under the five-year plan have been more than encouraging. The budget deficit for the year was reduced by fully four percentage points to under 5 percent of GDP. While oil revenues recorded a modest increase in 1996, tax revenues experienced a healthy 20 percent increase. Of significant importance, substantial progress was made on the expenditure side of the budget where for the first time in recent years a drop in nominal terms, of some 2 percent from 1995 levels, was achieved. This reflected in part the implementation of the first stage of an ambitious civil service retrenchment policy expected to lead to the

retirement of 22 percent of Omani civil servants by end 1998. This first stage entailed the retirement of more than one-third of the number of civil servants targeted for the whole program. In addition, the number of expatriate civil servants was also reduced by 7 percent during 1996. The civil service reform program represents a courageous break from the government's policy of guaranteed employment for all Omanis. Durable expenditure reduction is also expected from the privatization implemented in 1996, as well as the merger of two public sector banks, and the partial closure (expected to be fully completed in 1997) of the marketing board for agricultural products. The stricter procedures that have been put in place for expenditure authorizations by ministries to deal with the recurrent problem of expenditure overruns are also expected to make a lasting improvement in expenditure control. The previous practice of granting expenditure allocations on a continuous basis was replaced by a single supplementary budget law, in midyear, requiring the approval of an interministerial financial committee, the cabinet, and finally a Royal Decree. It is also noteworthy that the decline in overall expenditures was effected despite a doubling of the budget allocation to the human resource development program, a central component of the authorities' development strategy. This reallocation represents a welcome shift in budget outlays and contributes to the promotion of the private sector.

The government's 1997 budget reflects the firm determination to pursue fiscal adjustment as planned. The budget projects a further decline in the deficit, which is conservatively estimated to reach 4 percent of GDP, but which is expected by the staff to be closer to 3.4 percent of GDP. The adjustment is based on a projected reduction in current expenditure of 3 percent of GDP, resulting primarily from the durable effect of structural measures initiated last year, and a conservative estimate for revenues which are also projected to decline by 2 percentage points of GDP. In accordance with the authorities' FFYP any oil revenues in excess of budget estimates, which are based on an oil price of $15 per barrel, will be transferred to the SGRF. The authorities intend to implement firmly the budget as planned and are confident that the improved expenditure control measures described above will prevent the recurrence of expenditure overruns.

The authorities have continued to pursue a prudent monetary policy aimed at maintaining a stable nominal exchange rate and continued price stability. The capital position of banks has improved substantially and considerable progress has been achieved in the area of banking regulation and supervision. An early warning system in the form of a bank off-site surveillance unit in the central bank should be formalized very soon. The central bank is closely monitoring private sector credit developments, including the possibility that part of that credit is being channeled into speculative stock market participation. To control speculation banks were advised to retain 15—20 percent margins on loans granted for stock market activities, and primary investors were required to observe a lock-in period of two years before divesting themselves of the assets. Building on the substantial experience it has gained in treasury bill auctions, the central bank also is considering deepening financial markets further through the introduction of bills of longer maturities, moving to indirect monetary controls, and developing

a secondary market for treasury bills. The authorities are hopeful that the implementation of the strong medium term fiscal consolidation effort will reduce potential pressures on monetary policy, permitting a reduction in interest rates and further encouraging private investment.

The government is committed to the diversification of the economy through improving the investment climate for the private sector, including through privatization and encouraging foreign investment. The coming on stream of the LNG project in the year 2000 and the establishment of gas based industries now under consideration are expected to contribute significantly to the diversification of the country's production and export base. The private sector is also being encouraged to participate in infrastructure projects such as sewage, water distribution, power plants and roads. Already one power station has been built and operated by private investors. Vocational training programs are also being intensified and are expected to contribute to a further diversification in the private sector.

In conclusion, developments in 1996 confirm the authorities' commitment to strengthening the country's finances in the context of their ambitious medium term strategy. They fully intend to persevere in the difficult but necessary task ahead to meet the challenge of sustaining strong economic growth into the future.

Mr. Trivedi, speaking on behalf of Mr. Sivaraman, made the following statement:

The Omani economy grew at a comfortable rate of 6 percent in the first half of the nineties, although it slowed down last year by 2 percent. The inflation has been under control, the official fiscal deficit reduced, SGRF assets grew and the external current account balance achieved.

These positive developments were however shadowed by the concerns about overruns on total expenditure. And this is also one of the main concerns of the staff report. The Omani authorities are fully aware of these issues and Mr. Shaalan's statement also confirms it. The fact, nevertheless, remains that Oman's current expenditures at 36 percent of GDP is one of the highest in the world. Also the ratio of oil revenues to total expenditures at about 60 percent is also very high especially in face of the fact it has been so for almost the last five years and the fact that the non-oil revenue base has also been limited even though non-oil revenue has shown a healthy rise. This clearly emphasizes a need for a broad based tax structure for Oman so that dependence on oil revenues can be slowly reduced. The Omani authorities have passed a Fifth Five Year Plan with fiscal adjustment as its main focus and it aims at a fiscal balance by the year 2000. The main areas of fiscal consolidation should be the current expenditure. The government has taken a number of bold measures such as reducing the number of civil servants and checking expenditure overrun. Another pertinent question is the impact of fiscal consolidation on the non-oil real GDP growth rate. The staff analysis shows that the impact is significant in the case of Oman, although tempered in recent times by the growth of private sector. This issue gets more serious if we look at the limited life of 16 years of proven oil reserves in Oman and the fact that the SGRF,

created to partly compensate for the revenue after the oil reserves are exhausted, has also not accumulated sufficient assets. These points may be kept in view while formulating policy in Oman.

Comparison between the Omani economy and the Indonesian economy by the staff does not appear appropriate as they are different in many respects. Indonesia is a rapidly industrializing economy with a reasonable agricultural base and strong domestic labor. Solutions to Oman's problems should be based on its economic structure. Oman should accept a medium term fiscal policy based on a broad tax frame and expenditure based on critical analysis of its requirements. There should be a move away from oil dependence and oil reserves should only be used as a last resort.

The monetary policy in Oman has been very cautious and it has borne fruits in terms of a stable exchange rate and continued price stability. As far as banking is concerned, the expansion of credit into speculative stocks needs to be carefully monitored. Toward this end the authorities have advised the banks to maintain a margin and lock in the assets for a period of two years. I would like to caution that this lock-in may sometimes be detrimental to the interests of small investors who cannot sell to take advantage of market movements in prices and will entail rigidity in the market.

Finally, we are happy to note that Oman is rapidly diversifying its manufacturing base and expanding exports and the authorities will persevere in this process. In this endeavor and their medium term fiscal consolidation strategy, we wish the authorities best in the future.

Mr. Shaalan remarked that, while the current expenditures in 1995 had amounted to almost 36 percent, they had fallen by 4 percentage points in 1996 as a result of the reorientation of economic policies in the context of the five-year plan. The staff expected that this trend would continue, with the 1997 current expenditures projected to decline below 29 percent.

Mr. Al-Turki made the following statement:

Oman's economic progress remains impressive. The authorities can justly take credit for policies contributing to the sustained mix of robust growth, low inflation and a comfortable external position. The challenge now is to build on the progress achieved so far.

The key issues and policy priorities are clearly laid out in the staff's very well-written and insightful report. The buoyancy of private industry, transit trade, banking and the securities market indicates a continued broad-based growth in non-oil output. Also, prospects have brightened as work is speeding up on development of the natural gas and tourism potential. Clearly, sustenance of this effort will require above all a commensurate rise in public and private savings. The authorities' renewed priority for fiscal consolidation, improved savings intermediation, and increased foreign investment is thus well-placed.

On the fiscal front, the goal of balance in the central government budget by the year 2000 is appropriately ambitious. The authorities' determination in that regard is evident in the 1996 budgetary improvements which reflected strengthened expenditure controls and increased non-oil revenues as well as effects of the oil price recovery. It is particularly commendable that the difficult commitments on civil service retrenchment and lowering government services were carried out. It is also notable that these initiatives are to be deepened in 1997. Given the past track record, I share the staff's optimism regarding the fiscal outcome for 1997.

Monetary policy rightly remains focused on exchange rate and price stability. Maintenance of the excellent record on inflation containment will certainly be crucial for success of the economic diversification effort. In this connection, I am encouraged by the authorities' ongoing efforts to further strengthen the banking system. The proposed deepening of the treasury bills market and indirect monetary controls are steps in the right direction. Regarding the buoyancy in private credit, I am reassured by the authorities' determination to keep a close watch on the rise in personal loans for stock market investment.

Increased privatization and foreign direct investment are indeed critical for the growth and diversification strategy. The staff report details the extensive ongoing program on both fronts. The strategy of selling government shares in the stock market will not only enhance privatization but will also help deepen and broaden the capital market. I am encouraged by the increased private sector participation in the infrastructural projects. The realization of privatization benefits through outsourcing of the billing, collection and distribution operations of the public utilities is also welcome. In this connection, the recent improvements in the legal and tax environment for foreign investment are clearly steps in the right direction.

A growing private sector is the best vehicle for expanding employment opportunities for Omani nationals. This is especially the case given the ongoing retrenchment in the public sector. The authorities' emphasis on training and education should also facilitate the placement of Omanis in the private sector over the medium-term. In the meantime, the limited fees imposed on foreign labor will not only raise revenues but also improve employment opportunities for Omani labor here. One should remember that Oman has a very liberal labor policy and that these fees will likely have a minimal impact on competitiveness.

With these remarks, I wish the authorities further success.

Mr. Daïri made the following statement:

The performance of Oman's economy continues to be impressive with high growth, subdued inflation, and a strong external position. This achievement reflects the authorities' efforts at maintaining sound macroeconomic policy, within an open exchange and trade system, and improving incentives for private sector development and economic

diversification. The authorities are to be commended for their overall economic performance as well as for the significant improvement in social indicators.

The use of the State General Reserve Fund (SGRF) in 1992–95 to partly offset the effects of the sharp decline in oil prices was limited, and the authorities resumed accumulating reserves as soon as oil prices started to pick up. This allowed the non-oil sector to maintain a healthy pace of growth despite the dampening effect of lower oil activity without creating pressures in terms of inflation or external position. Indeed consumer prices declined in 1994 and 1995, increasing thereafter in 1996 by a modest 2 percent. Non-oil exports more than doubled during 1992–1996, and the government's foreign investments in 1997 are expected to exceed their peak of 1992. Over the same period, the debt to GDP ratio declined, and central bank's own reserves were maintained at the equivalent to six months of imports.

While the fiscal stimulus was temporarily used to partly offset the terms of trade shock, the authorities endeavored to bring down the deficit, mainly through expenditure restraint. Excluding receipts from reserve funds, the overall deficit declined from 12.2 percent of GDP in 1992—the previous oil price peak—to less than 5 percent in 1996. This was achieved mainly through cuts in current spending and, to a lesser extent, in capital spending.

In the context of a fixed exchange rate, prudent monetary policy, and improved private sector activity, the authorities' use of fiscal stimulus seemed appropriate. The use of assets served one of the main purposes of their build up, that is to absorb excessive oil-related shocks. However, the authorities should not lose sight from other significant purposes: to improve prospects for diversification and private sector development, and to prepare for the post-oil era. In this respect, I broadly agree with the staff's analysis and recommendations as regard future challenges.

I welcome the authorities' recognition that expansionary fiscal policies, even when successful, could not be sustained as indicated by Mr. Shaalan in his helpful statement. I concur with the staff on the appropriateness of the ongoing fiscal consolidation under the fifth development plan that has achieved so far substantial progress. However, a strengthening of expenditure control is called for in order to attain the fiscal balance objectives by 2000. Strict adherence to the plan is key to strengthening the private sector confidence and the realization of diversification efforts.

The authorities' intentions to broaden and modernize the treasury bill market are welcome. I support the staff's recommendation for additional interest rate and credit liberalization, as well as for greater role for indirect monetary control. I also share their cautious note regarding personal loans for stock market investments, and I would welcome some clarification from the staff following Mr. Sivaraman's comment on this issue.

On labor market issues, I welcome the authorities' liberal employment policy with regard to expatriate workers. While I agree with the staff on the need to avoid distortion in the labor market, I understand the authorities'

objective of reducing the high unemployment rate among Omani nationals. Setting quantitative targets for employment of nationals may not be the best means of achieving the authorities' objective, and I agree with the staff on the need to reduce the gap between public and private sectors' wages and to increase productivity of Omani labor through training. In this respect, I support the authorities' national vocational qualification program. However, in the case of Oman, I am not convinced that taxation of foreign labor is distortionary. Stricter immigration policy would be even more distortionary, and would effectively translate into much higher and less transparent increase in input costs. More generally, and, as this chair has indicated in the Board discussion of Article IV consultation with Saudi Arabia, I feel that the staff is not dealing with immigration issues in an evenhanded manner. If the Fund is to deal with such issues, it should pay as much attention, or even more, to policies applied in industrial countries where more liberal policies may be warranted in the context of a globalized world economy.

The outlook for the Omani economy is promising and has been further improved as a result of recent gas discoveries. This increases the prospects for higher investment and growth, both in the hydrocarbon sector and processing activities and in nonhydrocarbon sector. For the latter to materialize, more needs to be done to improve the private sector role, including in infrastructure and public utilities. I support the authorities' policies in this area, including their privatization program.

I wish the Omani authorities every success in their endeavors.

Mr. Fukushima made the following statement:

I commend the authorities' efforts under the First Five-Year Plan and the remarkable progress in the areas of fiscal consolidation, inflation, and the external sector.

Higher oil prices contributed to the decrease in the fiscal deficit in 1996. But as oil prices are expected to decline in the years ahead, further fiscal consolidation will be required. Steady implementation of the medium-term fiscal consolidation plan, as well as strengthening of non-oil revenue will result in a balanced fiscal position by the year 2000.

Further liberalization of the financial sector is also needed. I expect the liberalization will improve the effectiveness of monetary policy as well as contribute to a rise in the saving rate. The sound condition of the banking system is encouraging. The establishment of an "early warning system" is also welcome.

On structural policy, diversification of the economy and "Omanization" of the labor force are crucial for ensuring sustainable growth. In this regard, it is encouraging to know that vocational training has been implemented.

Finally I would like to thank Oman for its contribution to the stabling of the global oil market.

I wish the authorities well.

Mr. Brooke made the following statement:

I agree with Mr. Al-Turki that the performance in 1996 in terms of fiscal consolidation was very impressive. However, the adjustment process certainly has some way to go and leaves no room for complacency.

The expenditure overshooting relative to budget targets is a source of concern and highlights, possibly, two issues. First, the question whether the original targets were unrealistic; and, second, whether there was a need to further tighten expenditure control procedures. I suspect that the authorities need to make improvements in both areas.

Given Oman's oil dependence, further fiscal consolidation should also rely on improvement in non-oil revenues. In this respect, I endorse the staff message of expanding the scope and coverage of income taxation and introducing a broad-based sales tax.

Finally, I agree with Mr. Daïri's comments about the need to address the dualism in the labor market through narrowing of the differential between public sector wages and benefits and those in the private sector.

The staff representative from the Middle Eastern Department noted that the monetary survey for end-of-year 1996 indicated a decline in the share of personal loans. Claims on the private sector, of which personal loans generally accounted for 30 percent, had declined between November and December, from 16.5 percent of broad money to less than 14 percent. That represented a welcome improvement, although the staff was not aware of any well-defined policy changes on the part of the government. Perhaps some intervention or greater scrutiny might have played a positive role in that area.

The staff assessed the taxation of inputs on the basis of economic efficiency, the staff representative continued. It was certainly true that the labor market in Oman was one of the freest in the world, and the private sector was using that openness quite effectively in its hiring policies. The staff had also taken note of the impressive performance in the area of vocational training. Given Oman's open economy, the economy's competitiveness derived in part from the efficient labor market. However, the staff favored reliance on consumption taxes, or, as second best, income taxes, to raise revenue, rather than on input taxes because those tended to be distortionary with respect to the choice of inputs.

Mr. Daïri remarked that, while the input tax was distortionary, it was preferable to restrictions on immigration, for example, which would be the equivalent of an unlimited rate of taxation and would suffer from lack of transparency.

The staff representative from the Middle Eastern Department noted that international oil prices had declined recently and the World Economic Outlook projections had been revised downward as well. The staff had made a preliminary assessment of the impact of the lower

petroleum prices on the short-term and medium-term fiscal outlook. In 1997, the surplus in the central government, including SGRF operations, would be only 1 percent of GDP, instead of 5 percent. The medium-term outlook would not be affected because the petroleum price revision was essentially limited to 1997 and 1998. Hence, for 1999 and beyond, the outlook remained much the same. According to the adjustment scenario, the authorities should be able to attain a balanced budget position by the year 2000, although the accumulation of SGRF in the meantime would be somewhat lower, particularly in 1997 and 1998.

Mr. Shaalan emphasized that the Omani authorities were fully aware of the budgetary situation. In 1996 they had initiated a five-year program aimed at attaining fiscal balance by the year 2000. In the first year, they were on target. Extrabudgetary outlays had presented a problem in Oman in recent years. In response, the authorities had introduced a single supplementary allocation at midyear—that would be subject to a royal decree—that replaced a continuous supplementary budget. Furthermore, expenditure controls over the spending ministries were being strictly enforced. Indeed, the results of those initiatives had been reflected in the outcome for 1996 and the projected outcome for 1997.

Regarding labor policies, Mr. Shaalan said that he agreed with Mr. Daïri's comments, and noted that the 22 percent reduction over a three-year period in the size of the Omani civil service—more than a third of which had already been implemented in 1996—was similar in proportion to the decline in the number of expatriate civil servants that had taken place during 1996.

The Acting Chairman made the following summing up:

> Executive Directors were in agreement with the thrust of the staff appraisal. They commended the authorities for Oman's continued strong growth performance and remarkable price stability in the context of liberal trade and exchange systems and a stable currency. They noted with satisfaction the increased participation of the private sector in economic activity. Nevertheless, Directors underscored the importance of medium-term fiscal consolidation, since the past policy of sustaining domestic economic activity through an expansionary fiscal stance had its costs in the form of large budget deficits and substantial liquidation of government foreign investments, as well as inadequate restructuring of the economy and a widening gap between savings and investment.
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> The challenge for the period ahead was to build on the progress achieved. In that regard, Directors welcomed the government's medium-term objectives formulated in the context of the Fifth Five-Year Plan (FFYP), which aims at mobilizing national savings, achieving a balanced budget position by the year 2000, and enhancing the role of the private sector through diversification and broadening of the non-oil sector.
>
> Directors welcomed the significant fiscal adjustment achieved in 1996—the first year of the FFYP. They called for the continued steadfast implementation of sizable expenditure cuts and better expenditure control to help achieve the medium-term fiscal objectives. Nevertheless, they noted with concern the expenditure overruns experienced in 1996, which, if unchecked, could undermine the government's fiscal consolidation plan for 1997 and in the

medium term. Directors emphasized that delays in fiscal adjustment—as demonstrated in the staff's illustrative alternative medium-term scenarios—could lead to liquidation of foreign investments and increased external debt, which would impinge on private sector confidence and lead to higher adjustment costs. Directors also emphasized the need to broaden the tax base so as to reduce the dependence on oil revenue over time.

Directors noted Oman's continued prudent stance of monetary policy and its positive impact on price stability and enhanced external competitiveness, and called for continued focus on these objectives. They welcomed the authorities' efforts to widen and deepen the financial system and move to indirect instruments of monetary control. The authorities were also encouraged to continue their efforts in strengthening the prudential and regulatory framework, to monitor closely the increased use of personal loans for stock market investment—as evidenced in 1996—and to take any necessary prudential measures.

Directors observed that sustaining Oman's non-oil economic growth would also require an increased role of the private sector through privatization and the introduction of other real sector structural reforms, which would provide a favorable environment for private investment. They also encouraged the authorities to remove the remaining bias against foreign investment and reduce the bias in favor of public sector employment by adjusting the public sector wage and benefits structure.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/97/25 (3/19/97) and EBM/97/26 (3/21/97).

7. OFFICE SPACE—PHASE III—FITOUT BUDGET—PART TWO

1. Appropriations for the construction of Part Two of the Phase III Fitout work associated with the base construction of the Phase III addition to the headquarters building and associated design services and project operations, as described in EBAP/97/22 (3/13/97) are approved in the total amount of $10.3 million. This amount will increase the current Phase III Fitout budget of $11.8 million.

2. No commitment will be made that causes the revised Phase III Fitout budget of $22.1 million to be exceeded without prior approval by the Executive Board.

Adopted March 20, 1997

APPROVAL: October 30, 1997

REINHARD H. MUNZBERG
Secretary