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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/42

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

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

A.D. Ouattara, Acting Chairman
S. Sugisaki, Acting Chairman

Executive Directors	**Alternate Executive Directors**
A.A. Al-Tuwaijri	J.G. Borpujari, Temporary
	A. Fayolle
	L. Fontaine, Temporary
	C.X. O'Loghlin
	W.-D. Donecker
	R.J. Heinbuecher, Temporary
	N. Coumbis
	A. Giustiniani, Temporary
	J.N. Santos, Temporary
	J.M. Jones, Temporary
	T. Berrihun, Temporary
	R.F. Cippa, Temporary
	J. John, Temporary
	J. Prader
	B.S. Newman
	D.G. Loevinger, Temporary
A. Mirakhor	T. Schneider, Temporary
	M. Daïri
	A. Vernikov
	E. Kouprianova, Temporary
	J. Shields
A.S. Shaalan	Y.Y. Mohammed
	G.M. Iradian, Temporary
M.R. Sivaraman	R. Kannan, Temporary
E. Srejber	
	J. Guzmán-Calafell
	M.B. Alemán, Temporary
E.L. Waterman	
J. de Beaufort Wijnholds	E.T. Rădulescu, Temporary
	A. Barro Chambrier
Y. Yoshimura	Y. Tahara, Temporary
	Phan M.H., Temporary
Zhang Z.	Zheng Z, Temporary
A.G. Zoccali	

R.H. Munzberg, Secretary
A. Mountford, Acting Secretary
S.W. Tenney, Assistant

Also Present

IBRD: M.G. Ghattas, F. Nsengiyumva. African Department: E.A. Calamitsis, Director; K.J. Cady, J.E.J. de Vrijer, I.A.H. Diogo, M. Fouad, M.W. Lewis, M.I. Matungulu, P.C. Rother. Legal Department: H. Cisse, P. de Boeck, L.E. Nordgaard. Middle Eastern Department: M.A. El-Erian, Deputy Director; V. Sundararajan, Deputy Director; S.N. Erbas, H.P.G. Handy, H.E. Jakubiak, A.H. Mansur, H.M. Petri. Policy Development and Review Department: S. Chami, N.L. Happe, O. Havrylyshyn, T. Nishizawa, C. Puckahitkom, N. Tsaveas. Secretary's Department: K. Friedman. Treasurer's Department: W.J. Byrne, J.C. Corr, G.M. Fitzpatrick, C.A. Hatch, B.E. Keuppens, K.M. Kenney, H.R. Lorie, B.C. Yuen. Office of the Managing Director: P.J. McClellan. Advisors to Executive Directors: A. Cserés, S.S. Farid, C.M. Gonzalez, A. Guennewich, B. Konan, M.F. Melhem, H. Mori, S. N'guiamba, O. Otazú, T. Turner-Huggins, L.B.J. van Geest. Assistants to Executive Directors: W.F. Abdelati, H. I. Abdul Rahman, M.A. Brooke, K. Brownlee, M.A. Cilento, C.K. Duenwald, S. Fukushima, D. Giga, W.K. Gruber, D. Merino, I. Moon, J.A.K. Munthali, M. Nemli, L. Palei, L. Pinzani, G.P. Ramdas, V. Rigász, S. Rouai, D. Saha, S. Simonsen, V. Trivedi, M. Vismantas, A.G. Yakub.

1. INCOME POSITION, PRECAUTIONARY BALANCES, AND BURDEN SHARING FOR FY 1997 AND FY 1998; AND SPECIAL CHARGES—REVIEW

The Executive Directors considered a staff paper on the review of the Fund's income position, precautionary balances, burden sharing, and special charges for FY 1997 and FY 1998 (EBS/97/62, 4/4/97; and Sup. 1, 4/17/97).

The Deputy Treasurer noted that the updated projections circulated on April 14, 1997 had indicated that the Fund's net income position for FY 1997 would be SDR 10 million larger than expected in the original projections. As that more recent projection was based on the actual outcome for the first 11 months of FY 1997 only, the outcome for the year as a whole could be somewhat higher or lower than currently projected, depending on actual developments during the month of April 1997, for which final data were not yet available. For example, a change in exchange rates could affect the actual outcome for the administrative budget.

The projections for FY 1998 had been revised to take into account the recent slight decrease in the SDR interest rate, the Deputy Treasurer said. Based on that revision, the coefficient for the rate of charge for FY 1998 would be 109.6 percent, rather than 109.3 percent, as originally expected.

Mr. Newman made the following statement:

> During 1994 and early 1995, the Executive Board considered a comprehensive reform of the financing of the Fund's operations. This review represented a response to widespread concerns that the present system lacked transparency, did not assure adequate resources in all economic conditions, and failed to produce an equitable sharing of the cost of Fund operations. Considerable progress was achieved in developing an amendment of the Articles of Agreement to apportion the Fund's administrative costs on the basis of quotas. However, ultimate success proved elusive, primarily due to differences of view on how to finance the Fund's reserves and precautionary balances, including the issue of a risk premium. Consequently, the Executive Board is still confronted with a complex system that is rife with cross subsidies that produce perverse incentives which undermine creditor willingness to provide financing, encourage debtors to borrow too much for too long, and enable some members to obtain the advantages of Fund membership without sharing fully in the associated costs.
>
> The current review provides a timely opportunity to assess whether a reform of the system to deal with these acknowledged shortcomings could command support. However, to avoid a repetition of past debates, I would like to suggest a somewhat different perspective on the issue.
>
> The financial operations of the Fund are similar to the activities of a commercial bank. Thus, the Fund obtains short-term resources from members which results in a liquid liability and those resources are provided to borrowers in the form of medium-term financing. While the Fund pays a short-term rate of interest on the resources it obtains, the rate of charge does not reflect the

maturity of its financing. Consequently, the spread between the Fund's interest expense (remuneration) and charges is insufficient to fully cover costs (i.e., administrative expenses, operational costs and reserves and precautionary balances). To generate sufficient revenue, the Fund relies on a number of alternative sources of revenue including surcharges on loans (i.e., the variable co-efficient); service and stand-by fees; and interest-free resources (primarily the unremunerated reserve position and the burden shared precautionary balances).

An alternative, more transparent approach might be to recognize the maturity transformation which Fund financial operations entail by setting a medium-term rate of charge and a short-term rate of remuneration. Such an approach would normally generate net income that could reduce or eliminate some of the special revenue sources on which the Fund now relies. A risk would remain that an inadequate spread between medium- and short-term interest rates or a low level of lending could result in insufficient income to meet administrative and operating expenses. In such circumstances, the Board would need to take appropriate actions to reduce expenditures and/or increase revenue. This risk could be reduced if the Fund would invest its precautionary balances in market-based assets rather than as a source of liquidity to finance Fund loans. A safeguard mechanism could also be created that would provide for contributions from all members in proportion to quota, possibly along the lines of the uniform adjustable norm previously considered by the Board.

This approach would not eliminate all the problems associated with the current system but it would provide for a more transparent and equitable arrangement and thus could help break the Gordian knot confronting the Board whenever it must decide on the level of charges, precautionary balances and burden sharing. Our discussion today highlights the current problem.

Thus, the staff suggestion to reduce the net income target in order to lower the rate of charge is likely to be viewed as tilting the current balance toward borrowers at the expense of creditors which have also contributed to the build up of precautionary balances. In these circumstances, a slower rate of accumulation of precautionary balances (SCA-1) might be viewed as more equitable as it would reduce burden sharing costs for both debtors and creditors. Nevertheless, the staff has objected to this course of action, albeit for reasons which are not entirely clear but may have to do with the difficulty of subsequently increasing burden sharing if the need arises due to the high majority vote that is required. A third course of action would be to eliminate the burden sharing arrangements entirely if the Executive Board concluded that precautionary balances are currently adequate although I suspect that borrowers would object that the cost of deferred charges would fall entirely on them through the effects on net income.

In these circumstances, the likely outcome is a stalemate in which no course of action obtains the necessary 70 percent majority and the current safeguard mechanism is invoked if Fund income is inadequate. Alternatively, the Board could decide on the course of least resistance by maintaining the status quo. The preferred course of action, however, might be to begin the process of making the financing of the Fund's operations more transparent, robust and equitable.

Mr. Mirakhor commented that, although some of the points raised in Mr. Newman's opening statement were valid, the analogy he had drawn between the Fund and a commercial bank could not be taken too far. No commercial bank held a hidden asset as large as the Fund's gold holdings, which were not valued according to market prices. Although it was uncertain whether or not the Fund's gold holdings would ever be used, they served as a means to offset potential risks to the institution.

Mr. Donecker said that agreed with Mr. Mirakhor that the analogy between the Fund and a commercial bank should not be exaggerated. At the same time, it should be borne in mind that no commercial bank would take on the risks associated with some of the countries that had entered into programs with the Fund. Indeed, one of the main purposes of the Fund was to help countries adopt the policies needed to improve their financial positions and, thus, gain access to commercial sources of finance. In such cases, the Fund was the main risk taker.

Mr. Prader stated that some of the proposals put forward in Mr. Newman's opening statement were intriguing. However, those proposals would need to be studied further before the Board could take decisions on them.

Mr. Mirakhor considered that Mr. Donecker was correct to point out that commercial creditors likely would not be willing to provide finance to some of the countries undergoing Fund-supported programs. At the same time, however, commercial banks did not impose the same kinds of conditions as the Fund on their lending.

Mr. Newman remarked that he had not expected the Board to take decisions on his proposals during the current discussion. Experience suggested that the Board would likely agree to continue to follow current policies with respect to the Fund's income position, burden sharing, and the rate of charge, because it was not willing to undertake the difficult studies and decisions that would be needed to change the current policies. Nevertheless, he hoped that his proposals could be taken up for serious consideration at a future discussion, perhaps at the next review of income, charges, and burden sharing.

In drawing an analogy between the Fund and a commercial bank, Mr. Newman stated that he had intended to point out that, while the Fund financed its operations on a short-term basis, it provided finance to members over the medium term. It was for that reason that the Fund had had to resort to the current distorted revenue-generating measures, which undermined transparency and were not equitable.

He agreed with Mr. Mirakhor that commercial banks did not employ the same kind of conditionality as that used by the Fund, Mr. Newman said. However, the current system was based on the incorrect assumption that it was necessary to subsidize borrowing by countries to entice them to undertake the kinds of adjustment programs recommended by the Fund. If countries relied on the markets, they would be forced to undertake more harsh and disorderly adjustment measures. Taking that into account, the fact that the Fund provided finance at all should be sufficient incentive.

Mr. Mirakhor commented that he hoped Mr. Newman was wrong in expecting the current discussion to result in an agreement to retain the current policies regarding the income position, burden sharing, and the rate of charge. In the light of recent developments and the Fund's current precautionary balances, it would be reasonable to reduce the net income target to 3 percent of reserves at the beginning of 1998 and to reduce the rate of charge accordingly.

With respect to Mr. Newman's arguments on the nature of Fund lending, it should be borne in mind that any "subsidy" involved in Fund financing was justified owing to the cooperative nature of the institution and because orderly and appropriate adjustment was a "public good," Mr. Mirakhor stated.

Mr. Yoshimura made the following statement:

> I found the opening statement made by Mr. Newman and the discussion between Mr. Donecker, Mr. Mirakhor, and Mr. Newman very interesting. Mr. Newman was correct to point out that the Fund is like a commercial bank to the extent that its finances its operations on a short-term basis, while it provides lending over a longer term. At the same time, Mr. Donecker and Mr. Mirakhor were correct to point out that, because the Fund is a public institution, it probably cannot use commercial or market mechanisms to bridge the gap between short-term funding and long-term lending. In that respect, the Fund is different from commercial banks.
>
> At the outset, I would like to commend the staff for the comprehensive paper currently under consideration. I will make a few comments on each of the four main issues raised for discussion.
>
> It is encouraging to note that the net income position for FY 1997 is expected to be SDR 10 million higher than previously projected, owing mainly to the recent repayment by Sudan and the higher SDR interest rate. The current system for determining the income position, namely, by setting a certain target for net income and adjusting the rate of charges accordingly, has contributed to the stability of the Fund's financial position. This system should be maintained in the next fiscal year.
>
> I commend the staff for its well-balanced analysis of the Fund's precautionary balances, as requested by the Board at the midterm review. The improvement in the precautionary balances over recent years, especially with regard to the quantitative aspects, is encouraging. Free reserves as a portion of nonarrears, nonrights credit outstanding at the end of this fiscal year exceeded 5 percent, which is at the high end of the range considered to be reasonable.
>
> The Fund can effectively fulfill its role only if has sufficient financial strength in relation to the world economy and an adequate financial position. The assurance of adequate financial strength would be achieved through an early conclusion of the Eleventh General Review of Quotas.
>
> The Fund's reserves should be sufficient to deal with unexpected changes in member countries' economies. However, it is counterproductive in terms of financial management to maintain reserves in excess of a reasonable level. As the staff points out, the level of precautionary balances should be judged from both a quantitative and a qualitative perspective, and attention

should be paid to uncertainties, such as the possible use of GRA resources for the interim ESAF and losses that could be incurred through the compulsory withdrawal of a member from the Fund.

Bearing in mind that the rate of charge can be adjusted at annual reviews and that the impact on financial management of a reduction of the net income target is small, there would seem to be room to reduce the net income target from 5 percent of reserves to 3 percent of reserves at the beginning of FY 1998. We should not neglect the potential risks, such as the concentration of credit to certain countries and the increasing portion of credit to members whose programs have gone off track. But, in light of the increase in reserves plus balances in the SCA-1 compared with the current level of arrears, flexible use of SCA-1 should be considered. This is also the case with respect to the use of SCA-2. These risks should be addressed by preventive measures, such as strengthening the conditionalities and safeguards associated with programs that entail large amounts of access.

The staff paper indicates that abolition of the current burdening sharing mechanism would have an impact on the income position equivalent to a 13-basis point increase in the rate of charge. This shows clearly the importance of the burden sharing mechanism. This mechanism should be maintained in the coming fiscal year, but the equality of burden sharing among member countries should be improved through, for example, flexible management of the operational budget.

At the previous discussion on special charges, the Board considered possible alternatives to the current system. Therefore, it is disappointing to note that the staff has proposed abolition of the system without further considering possible alternatives. As this chair has indicated on previous occasions, the Fund should pay close attention to securing repayment, especially given its nature as a financial institution with revolving resources. Although the staff states that the special charges actually received do not cover the cost of maintaining the system, this question should be considered from a broader perspective than that of cost effectiveness. I would urge the Fund to maintain the system of special charges, with modifications to increase its efficiency.

Mr. Mirakhor said that he was grateful to Mr. Yoshimura for his nontraditional statement. He fully agreed with Mr. Yoshimura that it would be counterproductive to maintain reserves beyond a reasonable level.

Mr. Guzmán-Calafell made the following statement:

The Executive Board has agreed to base judgments on the adequacy and the appropriate rate of accumulation of precautionary balances on two guiding principles: these balances should fully cover outstanding credit to members in protracted arrears to the Fund, and they should also include a margin for the potential exposure to risk related to credit outstanding to other members. To take account of qualitative factors in the evaluation of risk, the

Board has deemed as reasonable to maintain precautionary balances within a range of 3 to 5 percent of credit in good standing.

At this stage, these indicators suggest that the rate of accumulation of precautionary balances can be reduced without unduly affecting the Fund's exposure to risk. As shown in Table 6 in the report, the ratio of reserves plus SCA-1 as a proportion of credit to members in arrears more than doubled from 1993 to 1996, and has risen further during the first months of 1997. By the end of this fiscal year, this ratio is expected to reach nearly 260 percent, i.e.,. roughly 2.6 times the figure considered as acceptable under our guidelines. The other central indicator, namely free reserves as a proportion of nonarrears nonrights credit outstanding, is projected to rise from only 0.9 percent in 1993 to 5.1 percent at the end of April of this year, thus exceeding the range which the Board has seen as reasonable on previous occasions. Other indicators point in the same direction. Such is the case for instance of the Fund's precautionary balances as a percentage of total credit outstanding. In addition, it has been repeatedly argued by a number of Directors that the undervaluation of gold in the financial statements provide additional margins of safety to the Fund which have not been duly recognized.

The staff makes reference to a number of qualitative factors that must also be taken into account in evaluating the adequacy of the Fund's precautionary balances. Let me say in the first place that, as explained by the staff in the report, the objective behind the specification of a margin and not a fixed proportion as a target for the ratio of precautionary balances to nonarrears nonrights credit outstanding, is precisely to take account of qualitative factors of risk. This should by itself obviate the need to discuss the creation of additional precautionary balances on this account. However, even disregarding this element, the extent to which the qualitative factors mentioned in the report warrant the continuation of the current pace of accumulation of precautionary balances is not evident for a number of reasons.

First, the staff note the possible financing of "interim ESAF" purchases with GRA resources and its implications on the Fund's exposure to credit risk. Nevertheless, there are still considerable uncertainties regarding the amounts, timing and the involvement of GRA resources for this purpose. Even assuming that some general account resources are used, this would still take several years. It does not make much sense to determine the present pace of reserve accumulation on the basis of an event that will probably occur after several years.

Second, as the staff note, with the termination of SCA-2, outstanding purchases arising from the encashment of rights that were previously protected in full by the SCA-2, would need to be covered by other precautionary balances. The staff suggest that this is not a very relevant factor, since with the termination of the SCA-2 the key ratio of free reserves to nonarrears nonrights credit would be affected only marginally. I would add to this that the exposure derived from the completion of rights accumulation programs is explained in full by one country, and it is far from obvious that the risks originating from this source warrant the accumulation of more reserves than in the case of other nonrights countries.

Third, on the implications of a possible compulsory withdrawal of a member from the Fund, I would say that I have no reason to believe that the risks derived from Sudan are higher today than a year ago, and we do have stronger precautionary balances than a year ago. Also, as the staff explain, if Sudan were to be required to withdraw, the Executive Board will need to reconsider whether, how, and to what extent a probable loss would need to be recognized and how provisions would need to be financed.

I would like to hear the staff's reaction to these comments.

For the reasons explained above, I am convinced that there is room for a reduction in the rate of accumulation of precautionary balances, through decreases in both the target amount of net income and the pace of accumulation of balances in SCA-1. However, I am willing to heed the staff's advice to err on the side of caution, and therefore I can support their proposal that the slowdown takes the form of a reduction only of the target amount of net income, from 5 percent to 3 percent of reserves at the beginning of the year. The staff note that the impact of a moderate reduction in the rate of accumulation of precautionary balances would be relatively small. But I wish to stress that even with the reduction of the net income target to 3 percent, all the relevant ratios would continue to improve during the next fiscal year compared to their current levels. For instance, Table 6 shows that under this assumption reserves plus SCA-1 as a proportion of credit to members in arrears would increase from 256 percent in February 1997 to 273 percent in April 1998; similarly, free reserves as a proportion of nonarrears nonrights credit outstanding would rise from 5 to 5.1 percent in the same period.

On the issue of special charges, it is not difficult to see that so far their usefulness as a disincentive to the emergence of overdue obligations has been questionable. In addition, the system represents a source of costs to the Fund. Since the system has not worked, retaining it on the grounds that its abolition could give a misleading signal of relaxation is not a very persuasive argument. I also note the staff's comment about the low level of accruing special charges, and its link to the Fund's efforts to contain the number and duration of instances of short term arrears. In this context, I can support the proposal to abolish this system.

Finally, while I support the other decisions proposed by the staff in the report, I would only like to stress that the current burden sharing mechanism imposes an excessive burden on debtor countries, and I believe that we should continue looking for ways to make it consistent with the quota-based nature of the Fund.

Mr. Donecker made the following statement:

Allow me to summarize our position on the issues for discussion today as follows:

Firstly, there are a number of very good reasons why we should continue with our net income target of 5 percent of reserves for financial year 1998.

To name but a few that were also mentioned by the Treasurer's Department: The concentration of Fund credits to some members with stabilization programs is high and is likely to increase. Fund credit to members with programs that are off track has increased considerably. The fact that this increase is largely due to the failure of one large debtor to achieve his program targets is by no means comforting but rather adds to my concern. The record number of Fund programs and the persistent prolonged use of resources by some members also raise the question whether programs have sufficient strength. This also calls for a more prudent reserve level. Moreover, we have not achieved much further progress with the reduction of the hard core arrears to the Fund during financial year 1997. The political and economic situation in most of these arrears countries remains very serious or is even worsening. One more reason to at least maintain the momentum in building up the Fund's reserves and to continue with burden sharing.

In addition to these risk factors, it should also be taken into account that the likely use of SCA-2 balances for financing operations under the ESAF and the participation in the HIPC Initiative will result in very substantial reductions of the existing level of precautionary balances by SDR 1 billion. So there is no room for complacency here.

In a nutshell, given the points mentioned, we believe a reduction of the net income target for FY 1998 would raise doubts regarding the soundness of the financial management of this institution. This could also impair the willingness of member countries to contribute to the financing of the Fund via the currency budgets.

Secondly, the participation of creditors in the burden sharing for deferred charges and the SCA-1 is a unique feature resulting from the cooperative nature of this institution. Despite our well-known misgivings about the Special Contingent Accounts and strong preference for a straight forward strengthening of the Fund's reserves we are willing to continue with the burden sharing for deferred charges and SCA-1 in financial year 1998 with the understanding that the Board will agree to also maintain the present net income target of 5 percent of reserves. Even though we would have preferred to somewhat reduce burden sharing for the SCA-1 to 3 percent of reserves in financial year 1998 in view of the aforementioned risks we are prepared to accept the proposed 5 percent target here in parallel to the 5 percent net income target for financial year 1998.

Finally, on special charges, we do not support staff's suggestion to abolish the system of special charges. We should be very careful not to give the wrong signals here in order not to weaken our enhanced cooperative strategy against arrears. The staff's pointing to the cost of administering the system does not constitute a compelling reason for an abolition of the system. In our view, the existence of special charges does provide an additional deterrent, respectively incentive to stay current with one's obligations vis-à-vis the Fund.

Mr. Shields made the following statement:

The opening statement put forward by Mr. Newman for the current discussion was very interesting. I fully agree with him that the current processes for determining the Fund's income position, precautionary balances, and burden sharing are overly complex and lack transparency. A great deal could be done to improve the transparency of the process as well as the efficiency with which Fund resources are utilized. More could also be done to provide a better mechanism for sharing the costs of administering the Fund.

Although Mr. Mirakhor and other Directors were correct to point out that the Fund's work represents a "public good," there is a need to share the costs of that "good" equitably and in a way that ensures that there are no perverse incentives that allow for abuse of the system. Therefore, the Fund should continue to examine ways to improve the way it charges for the use of its facilities. Past proposals for the use of a uniform adjustable norm did not garner sufficient support. However, it is important for the Board to remain flexible and open to new initiatives. I am grateful to Mr. Newman for raising the important points contained in his opening statement for the current discussion.

From the current discussion, it seems that some speakers and the staff are open to consider various issues related to the current system of charges. The staff was correct to raise the possibility of reducing the net income target somewhat, while continuing to build up the Fund's precautionary balances. From Mr. Guzmán-Calafell's opening statement and the staff paper, it would seem reasonable at some point to go for a smaller net income target. However, I would be loath to do so at the present stage, in light of the continued uncertainties. In that respect, I share the concerns raised by Mr. Donecker about the concentration of Fund finance to a few countries with large access.

I am also concerned about some other initiatives currently under consideration, including the possible use of the GRA to finance the ESAF initiative. Conclusions also have not yet been reached about the future of the SCA-2, not to mention the problems related to the case of Sudan. In the circumstances, I am not convinced that this would be an appropriate time to change the Fund's finances in a way that would give misleading signals. Nevertheless, we could return to the question of reducing the net income target once those uncertainties have been resolved.

I support the continuation of the present burden-sharing arrangements. Although the system of special charges may be ineffective to the extent that it is costly for the Fund to administer and it does not raise additional income, I continue to consider that the usefulness of the system cannot be judged on the basis of cost alone. Also, it is not possible to measure in precise terms the possible disincentive effects of the system. Some countries may have been making repayments in a more timely fashion than might otherwise have been the case. My suspicion is that there may be circumstances in which that disincentive could be useful. It clearly would be a mistake to abolish special charges if doing so could produce an incentive for some countries to delay repayments, which I believe would happen. Moreover, it would clearly be a mistake to do so at the present stage, given the continued serious problems related to cases involving deferred obligations and protracted arrears. I would not want to send a signal that the Fund was becoming more lax on those issues.

The questions raised by Mr. Newman concerning whether the Fund is using its resources effectively are valid. The Fund does finance its operations over a short-term horizon, while it provides finance to members over a longer time frame. Moreover, the Fund's rate of charge was set on a short-term basis. That fact gives rise to questions concerning the appropriate use of precautionary balances. It may be sensible to separate the precautionary balance from the rest of the Fund's resources, and perhaps seek market returns on those assets, rather than investing them in debtor countries. Such a change in the system would benefit other members of the Fund.

Mr. Mirakhor said that he appreciated the indication by Mr. Shields that the United Kingdom would be willing to consider a possible reduction in the net income target. However, it was disappointing to note that Mr. Shields was not willing to consider such a reduction at the present stage. Given that the Fund's reserves plus balances in the SCA-1 were estimated to be about three times the amount of outstanding credit to members in protracted arrears, it would seem both reasonable and appropriate to reduce the net income target immediately, rather than delay such a reduction until the distant future.

Mr. Newman asked Mr. Mirakhor why he would prefer to reduce the net income target rather than the rate of accumulations to the SCA-1.

Mr. Mirakhor responded that the issues related to SCA-1 should taken up separately from those pertaining to the Fund's net income position. The Fund had been setting its net income targets at high levels for some time, and many Executive Directors had been calling for a reduction in those targets for the past four years. However, other Directors had argued that such a reduction would not be timely, given the large amounts of credit outstanding and prevailing uncertainties about the ability of some members to make prompt repayments. From a historical perspective, an immediate reduction in the Fund's net income target would be not only timely, but also the most transparent way in which to acknowledge that the Fund's precautionary balances were adequate. In that respect, it should be noted that commercial banks would not consider it appropriate or financially wise to maintain such a high level of reserves.

Mr. Newman stated that commercial banks were different from the Fund in that they could write off bad loans, while the Fund did not. It was for that reason that the Fund had to ensure that its precautionary balances were sufficient to cover all unexpected contingencies. Against that background, he wondered why Mr. Mirakhor would prefer to lower the Fund's net income target, rather than slow the rate of accumulation of precautionary balances or reducing the total amount of burden sharing to cover only deferred charges.

Mr. Mirakhor considered that a reduction in the net income target would be the most transparent means by which to reduce the rate of charge on the use of Fund resources.

Mr. Shields commented that, even at the present stage, he would be reluctant to agree to a reduction in the net income target, given the substantial uncertainties facing the Fund. For example, even if all of the resources of the SCA-2 were used to help finance the initiative for Heavily Indebted Poor Countries (HIPC Initiative), there would still be a need to take into account the possible use of resources from the General Resources Account (GRA) to help finance the interim Enhanced Structural Adjustment Facility (ESAF).

More important, there were still significant uncertainties and risks emanating from the case of Sudan, Mr. Shields noted. Indeed, at previous discussions on Sudan, Mr. Mirakhor had been among the Directors who had warned the Fund against taking precipitous action, owing to the possible consequences of compulsory withdrawal on the Fund's financial position. Once Sudan showed that it was forcefully implementing a Fund-monitored program and it began to settle its overdue financial obligations, the Fund might be in a position to consider reducing the net income target. However, recent developments did not give much room for confidence that significant progress would be made by Sudan soon.

At the present stage, it would not be appropriate to reduce the net income target, given the current concentration of Fund credit to a few countries with large amounts of access, Mr. Shields commented. At least one of those countries had not been performing satisfactorily over recent months. Therefore, it would not be appropriate for the Fund to send signals to the markets or to debtor countries that it was not taking seriously the risks it faced.

Mr. Mirakhor recalled that, at recent discussions on Sudan, his concern had not been whether Sudan would eminently face compulsory withdrawal. Rather, his concern was that the Board might take premature decisions on Sudan that would force it into compulsory withdrawal, which would have consequences on the rate of charge and on the Fund's financial structure and, thus, on other members. Nevertheless, he was more optimistic than Mr. Shields about Sudan's prospects for improving its economic situation and its relations with the Fund.

In a spirit of compromise, and taking into account the concerns raised by Mr. Shields, he could agree to take a decision at the present stage to reduce the Fund's net income target to 3 percent of reserves at the beginning of FY 1998, but to raise the net income target back to 5 percent should Sudan be required to withdraw from the Fund, Mr. Mirakhor stated.

Mr. Al-Tuwaijri made the following statement:

> I welcome the further strengthening of the Fund's precautionary balances. As noted in the staff paper, the ratio of free reserves to nonarrears nonrights credit outstanding is projected by the end of the financial year to be above the upper end of the range suggested by staff. Accordingly, a strong

argument could be made for a slow down in the rate of reserve accumulation. At the same time, both the staff and other speakers, especially Mr. Donecker, advanced a number of valid reasons why caution may be needed.

Taking all these arguments into consideration, I lean toward maintaining the current net income target but could go along with the majority on this issue. Once we agree on a net income target, however, we should stick to it by retroactively reimbursing excess income and by recapturing shortfalls in the following period.

I support the proposed decisions regarding burden sharing and the disposition of net income for 1997.

While I do not feel strongly about the issue of special charges, I lean toward retaining them as an incentive for prompt payments.

Mr. Wijnholds made the following statement:

Maintaining a cautious approach with regard to the Fund's financial position remains important generally as a matter of ensuring indisputable financial soundness.

There are also some special considerations why I favor a continuation of the present pace of reserve accumulation for now.

First of all, SCA-1, the Fund's protection against arrears, is still insufficient to cover all credit to arrear cases. Moreover, the Fund's reserves are relatively small in comparison to those of other multilateral institutions. The World Bank's reserves to loan ratio of 14.1 percent compares favorably with our 10.8 percent. To this can be added the fact that the concentration of Fund credit is much larger than that of comparable institutions.

Second, agreement has been reached in principle to liquidate SCA-2. This will imply a heavier burden on the general and special reserves; the present ratio of precautionary reserves to credit outstanding will decline from 10.8 to 7.9 percent. Moreover, it cannot be ruled out that the interim ESAF will be financed through the GRA. This would not only imply a significant upward shift in net lending, it would also entail a riskier composition of our portfolio. There is also the question of Sudan and the months ahead are crucial to see if the country can stick to an adjustment program and payment schedule.

Against this background I would favor the continuation of the present Fund income target of 5 percent of reserves, as well as of the burden sharing decision.

Like Mr. Al Tuwaijri, I am hesitant to abolish the special charges.

We may have to come back to the matter of financial structure of the Fund. But chances are we will find ourselves in a stalemate again. Let me also say that while I agree with Mr. Newman that the present system has drawbacks and could be improved, for instance by adopting a uniform adjustable norm, I am less in agreement with him as regards his wish to remove or reduce the element of concessionality in the charges.

Mr. Mirakhor asked whether Mr. Wijnholds would agree that, in order to achieve greater transparency in the financial structure of the Fund, its asset portfolio should be priced to the markets, especially if attempts were to be made to place a value on the Fund's credit to debtor countries.

At past discussions on the proposed uniform adjustable norm, Directors had determined that its use might run counter to the traditional policies of the Fund, Mr. Mirakhor recalled.

Mr. Wijnholds commented that he would not wish to prolong the discussion by debating every intervention. He had not intended to suggest that he would support use of the uniform adjustable norm at the present stage. Rather, his statement was intended to indicate that, if there was an agreement among Directors to return to the issues related to the uniform adjustable norm, he would be willing to consider its possible use in the future.

Mr. Donecker said that his chair had been attracted to the proposed uniform adjustable norm, because it would provide a clear and transparent mechanism for sharing the costs of the Fund. Therefore, his chair would welcome a further discussion on that proposal.

Mr. Mirakhor commented that it was important to emphasize that every Executive Director had a right to ask for clarifications of the positions taken by other speakers. It would be very important not to constrain open and frank deliberations in the Board.

Mr. Iradian made the following statement:

The present level of Fund's precautionary balances are at a comfortable level, and there may even be room for a deceleration of the rate of reserve accumulation. As shown in Table 6 of the report, reserves plus balances in SCA-1 are projected to reach almost three times the level of protracted arrears by end-April 1998 (as compared to less than twice in 1995). Also, free reserves as a proportion of nonarrears credit outstanding continued to increase and are now close to 5 percent. We would also point out, as we have on the occasion of previous reviews of the Fund's income position, that the substantial difference between the market value of the Fund's gold holdings and the value reflected in the financial statement represents additional substantial hidden reserves that are not taken into account in our consideration of the adequacy of our precautionary balances. Once again, we would underscore the need to find a way to factor in these hidden reserves in our consideration of this important matter.

Notwithstanding these, we agree that there are elements of uncertainty and that we must continue to be prudent. In this connection, I note the continued increased concentration of Fund credit. At end-FY 1998, outstanding purchases by the three largest debtor members are projected to remain at about 60 percent of total credit outstanding. This suggests an added risk element that would need to be taken into account in the evaluation of the adequacy of the Fund's precautionary balances. However, as noted by the staff, the Fund's exposure to risk is more a factor of the design, implementation, and success of adjustment programs, than concentration of credit, which is of course only partly true. Another negative factor in the assessment of the adequacy of the Fund's precautionary balances, which should be taken into account, is the likelihood of compulsory withdrawal by a member from the Fund and its effect on SCA-1, although such risk today is much lower than in the past. On balance, therefore, we favor a net income target of 3 percent of the Fund's reserves.

Regarding the other issues raised in the paper, we agree with the staff's proposal that burden sharing of deferred charges and of contributions to SCA-1 be continued in FY 1998. Finally, we can also go along with the proposal to abolish the special charges on overdue financial obligations to the Fund. The cost of collection greatly exceeds the cost of recovery, and there is little indication that these charges are effective as a disincentive to incurring overdue obligations.

Ms. Srejber made the following statement:

Let me at the outset thank the staff for an interesting and pedagogical paper striking a proper balance between important issues as the speed of accumulation of precautionary balances and burden sharing and how these factors affect financial relations between the Fund and its members, as well as the Fund's own income position. In particular, I would like to commend the staff for the attached tables that have made an historical assessment of the speed of reserve accumulation easier than in former years.

This is welcome, as the adequacy of precautionary balances is the issue that has been important bearing on other issues raised in the document.

Even if there is broad agreement that the primary safeguard for the Fund's financial integrity lies in strong adjustment programs, it is also clear that strong programs can not eliminate financial risks for the Fund. There is no agreed or objective method to determine the Fund's financial risk and if we were able to agree and put a number on the risk, it would still be a matter of judgment as to what consequences it would have for the adequate level of precautionary balances. This is, in particular, true for a cooperative institution like the Fund which is owned jointly by all members.

It is my view that the speed of acquiring of precautionary balances should not be at each moment directly proportional to estimated changes in the credit risk but some stability in the speed of build up of precautionary balances is necessary. Nevertheless, risk assessment is and will continue to be, the most important factor when assessing the adequacy of reserves and we have to continue to develop appropriate risk evaluation methods.

For the sake of stability, I am inclined to put more emphasis on stabilizing the relationship between precautionary balances and total credit outstanding, rather than to overdue obligations or to credit to countries in arrears. We have for several years now concluded that a level of precautionary balances as a proportion of total credit outstanding of approximately 10 percent is not especially high, and I do see several recent developments that support a higher ratio, rather than a lower.

The concentration of Fund credit on some relatively large borrowers has not been reduced.

We have the uncertainty emanating from a possible compulsory withdrawal of a member.

The probable use of SCA-2 resources for the benefit of ESAF-HIPC necessitates a replenishment of other reserves.

Thus, while there has been a steady and welcome reduction in the ratio of credit in arrears to total credit outstanding, I find it—on balance—to be too early to reduce the speed of reserve accumulation, and hence I do not support a reduction of the income target from 5 percent to 3 percent for FY 1998.

I consider the present burden sharing arrangements to be a carefully negotiated balance between various interests. I do not consider the balance to be perfect, but I guess that we all have compromised on some elements when the balance was agreed. I will thus not ask for a change in elements of the mechanism today, but I agree with Mr. Prader that staff should look into Mr. Newman's proposal, which contains many interesting elements, and I would also like to remind that introduction of an adjustable uniform norm would distribute the burden of reserve accumulation quite differently—and in my view more fairly—between all members of the Fund. Does the staff want to comment on this today?

Finally, on special charges, there is a positive incentive effect in the system as it is today. There is also a moral argument that it is unfair that breeches against the system is not punished, even if the punishment draws resources. There might also be a negative signal effect of abolishing the system. On the other hand, it seems as if other mechanisms and measures to handle the overdue problem are reasonably effective. and staff therefore questions the rationality of continuing a complicated system that does not generate enough resources to cover the cost of its own administration. I can on balance reluctantly—and contrary to my position on this issue last year—support the abolishment of the special charges.

Mr. Giustiniani made the following statement:

We prefer to take a conservative approach with respect to the proposed decisions. This preference stems the risk borne by the Fund. The stock of overdue obligations in the GRA is still very high, and we have recently noticed a worrisome increase. As noted by Mr. Donecker, the projected increase in the concentration of Fund credit to a number of countries whose programs have gone off track is an indicator of growing risk. Moreover, the possibility of using GRA resources to finance the interim ESAF and the other initiatives that we are now under consideration also justifies a prudent approach. Therefore, it would be best to continue the present burden-sharing mechanism.

We support the decision to maintain the rate of accumulation of precautionary balances by maintaining the net income target of 5 percent of reserves. We would welcome further opportunities to consider possible alternatives to the current method of distributing excesses or shortfalls of income. We wonder whether income shortfalls could be recaptured by increasing retroactively the rate of charge, in the same manner that excesses in income can be offset through retroactive reductions in it.

The questions concerning the system of special charges cannot be judged only on the basis of administrative cots. Even though the system is a bit complicated, the difference between countries that are current in their repayments and those that are not should be maintained. Therefore, for the moment, we support the maintenance of the present system of special charges. However, this issue needs to be further analyzed by the staff. I wonder whether a straightforward system, like levying special charges in the form of constant increases in interest rates might be considered.

Miss John made the following statement:

Given the comfortable level of precautionary balances, consideration should be given to slowing the rate of accumulation. Nevertheless, we agree with other speakers on the need for caution, especially if expected developments in FY 1998 could risk undermining the Fund's financial position. In this connection, I look forward to the staff's responses to the questions raised by Mr. Guzmán-Calafell.

Our chair agrees to the continuation of the current burden-sharing mechanism and to the maintenance of the income target and the rate of charge in FY 1998. We have some concerns about the system of special charges, but, as we have not yet fully come to terms with how best to attain the desired objectives, we share the hesitation of Mr. Al-Tuwaijri and some others about abolishing it at the present stage.

Mr. Zoccali made the following statement:

We share the view expressed that the Fund is entrusted with providing a unique public good, i.e., that of facilitating an orderly process of international adjustment. Admittedly pricing this externality is not a straightforward exercise. We would thus welcome to continue looking for ways of sharing the costs of operating the Fund in a manner that is more transparent and consistent with its quota-based character. The Fund's precautionary balances as a percentage of total credit substantially exceed outstanding credit to members in protracted arrears. Moreover, as shown in Table 9 of EBS/97/62, precautionary balances as percentage of total outstanding credit, are now higher than during the debt crisis of the 1980s, providing a more than a reasonable margin for exposure to risk even when the Fund's immobilized hidden reserves are excluded.

Additionally, we consider the risk of failure to repay Fund credits to be low for the following reasons: First, the unique characteristic of the Fund of being able to limit its exposure to risk through the requirement of conditionality built into the design and implementation of adjustment programs, rather than through a build-up of precautionary balances. Second, its cooperative nature and the catalytic role of its support. This catalytic role, is particularly important for large users and more than offsets risk of arrears associated with an occasional concentration of Fund credit. Third, world economic growth has firmed in 1996 while a further strengthening with subdued rates of inflation is projected in medium term. Fourth, outstanding credit to members in protracted arrears at the end of fiscal year 1997 declined. Fifth, unlike other speakers who view the prospect of ESAF use and the implementation of the HIPC Initiative in the context of the ESAF as perverse, we consider that this would actually help to improve the incentives for adoption of higher quality adjustment programs by many members and the prospects of an exit from further debt relief. Thus, reducing the long-term risk of outstanding Fund credit. Sixth, the usefulness of rebuilding of precautionary balances to offset possible losses after a hypothetical compulsory withdrawal of a member from the Fund is not apparent since the ratio of "free" reserves as percentage of nonarrears, nonrights credit would not be affected.

Keeping in mind the asymmetry at the margin of the present mechanism for covering the costs of operating the Fund, the markedly higher level of reserves and staff's long standing practice to "err on the side of caution" when estimating the Fund's income position, which is expected to result in excess net income of some SDR 10 million for FY 97, we support a modest reduction in the rate of accumulation of precautionary balances. More specifically, we would favor lowering the target amount of net income from 5 to 3 percent of reserves at the beginning of FY 1998, while maintaining the current rate of accumulation of balances in SCA-1 and the practice of reducing retroactively the rate of charges in proportion to the SDR interest rate for FY 1998 if net income exceeds the targeted amount. We could also agree to revisiting the net income target if the compulsory withdrawal of Sudan should materialize.

We also agree with the proposed Decision No. 4 to place the Fund's targeted net income for FY 1997 in the Special Reserve.

Finally, regarding special charges, we fully concur with staff that the current system does not adequately meet its objectives, mainly recovering the costs to the Fund of short-term overdue obligations; provide additional incentives to those built into the arrears strategy for members to settle their obligations to the Fund on time. Keeping this system in place would be justified only to the extent that it provides significant additional disincentives for members to incur in new overdue obligations. In this regard, we share staff's view that the most cost-effective option would be to abolish the system of special charges altogether.

Mr. Zhang made the following statement:

We welcome the Board discussion on these important issues covered by the document before us today. I would like to join my colleagues in commending the staff for their well organized paper. Board decisions on these issues are critical not only in targeting the Fund's net income position for the year ahead, but also to consideration of the Fund's overall financial well being in conjunction with possible changes in its financial operations. I am in general agreement with the thrust of the staff projections and proposed decisions and would like to make a few comments for emphasis.

On the net income position of the Fund, while we are encouraged that the staff projects the net income for FY 1997 to be SDR 10 million higher than the net income target set for the year, to a large extent, this reflects the settlement of overdue charges and fees from undrawn Stand-By Arrangements. Therefore, this should not be regarded as an indicator of a significant improvement in the overall financial structure of the Fund. We are concerned about the changes involving the Fund's financial risks from a qualitative perspective. The proportion of credit to members with arrangements declined from 75 percent at end-FY 1996 to 61 percent in early March 1997 and the credit to members with programs that are off-track increased from 4 percent to 36 percent. What calls for our attention is the significant increase in the proportion of off-track credit reflecting, to a large extent, the program of one member. I agree with the staff that, in judging the adequacy of the Fund's precautionary balances, consideration should be given to other factors such as the effect of the possible use of GRA resources to finance the interim ESAF, the use of SCA-2 balances to finance the ESAF/HIPC Initiative, and so on.

I also wish to emphasize that the concentration of Fund credit has not changed very much since last year's review. Table 8 of the staff paper shows that the credit concentration percentages will even increase in FY 1998. The largest user and the five largest users of Fund credit that used 26.11 percent and 69.26 percent of Fund total credit at end February 1997, respectively, will increase to 30.23 percent and 71.85 percent by end FY 1998, respectively.

In light of these developments, we believe there is the need for the Fund to continue the practice of targeting the amount of net income for FY 1998 to be equivalent to 5 percent of the Fund's reserves at the beginning of the financial year. Accordingly, the coefficient for the rate of charge shall be set correspondingly. As the staff explained just now it should be at 109.6 percent of the SDR interest rate.

With regard to the issues of burden sharing, I can agree with the view that no further balances need to be accumulated in SCA-2 account, upon reaching its target of SDR 1 billion in the fourth quarter of FY 1997. We support the staff proposal on the continuation of burden sharing of deferred charges and of contributions to the SCA-1 for FY 1998, based upon consideration of the cost of overdue obligations on the Fund's income position.

With regard to special charges, we do not have difficulty in going along with the staff's view that the present system of special charges should be abolished.

Mr. Vernikov made the following statement:

I can go along with the proposed draft Decisions 1 and 2, although reluctantly with regard to the pace of accumulation of SCA-1 balances.

Regarding Decision 3, I welcome what I perceived as an evolution in the staff's views on the needed rate of accumulation of precautionary balances, namely a slowdown. I support the 3 percent income target for the next financial year since it reflects today's healthy reserve position of the Fund. Should the situation change, the Fund can always reconsider this target. My opinion is reinforced by the recent developments in the ratio of "free" reserves to nonarrears nonrights credit outstanding, which is now projected to reach a comfortable level of 5.1 percent by the end of the financial year. I share Mr. Yoshimura's view that reserves exceeding a reasonable level are counterproductive.

Mr. Guzman correctly noted that the interim financing of the ESAF is still subject to many uncertainties and it is questionable if it should be used in setting annual income targets. In any event, the use of GRA to finance the principal of ESAF loans is not on the agenda for the coming financial year. Finally, I endorse Mr. Mirakhor's point with respect to the probability of a member's compulsory withdrawal. Indeed, we have achieved some progress in addressing Sudan's situation, and the situation does not look worse today than a year ago. Compulsory withdrawal would be an undesirable and regrettable outcome of our efforts, and its likelihood does not seem to me to be higher now than before.

I have no problems with the draft Decision 4.

The arguments already presented in favor of abolition of the present burdensome system of special charges have been persuasive, so I would support the Alternate Decision 5 regarding discontinuation of Special Charges.

And now a short final comment: in Table 7 on page 30, six countries with protracted arrears are listed. I believe that the Fund is in a position to reduce promptly that number from six to five, by normalizing the membership of one of the countries mentioned.

Mr. Berrihun made the following statement:

We are pleased to note that the Fund's net income for FY 1997 is expected to be SDR 10 million higher than the target of SDR 94 million. We support the staff's proposal to place the net income in the Special Reserve.

As regards the net income target for FY 1998, as this chair has reiterated on previous occasions, it would seem appropriate to reduce the present rate of 5 percent of reserves, perhaps to 3 percent as suggested by the staff. This action is strongly warranted by the considerable improvement in the Fund's coverage against risk. The Fund's precautionary balances have increased considerably over the past 11 years. These balances, which were only about 3 percent in 1984, are now about 11 percent—almost a fourfold increase. In particular, reserves plus balances in SCA-1 at present represent more than two-and-a-half times credit outstanding to members in protracted arrears. Moreover, free reserves as a proportion of nonarrears, nonrights credit outstanding have risen sharply to over 5 percent from less than 1 percent in 1993.

It should be noted that, as was emphasized by many Directors on several previous occasions, the main protection against potential impairment of the Fund's assets comes from the strength and quality of Fund programs, which always take into account a member's capacity to pay. Any consideration of the adequacy of precautionary balances should also take cognizance of the positive impact of the strategy of prevention, deterrence, and remedial measures which so far has produced considerable success in redressing and containing the arrears problem. There is also the substantial cushion that is provided by the Fund's hidden reserves, should a need arise.

The concentration of Fund credit is noted in the staff paper as one of the relevant factors in assessing the adequacy of precautionary balances. High concentration may imply a somewhat greater exposure to risk. However, as rightly pointed out by the staff, the Fund's exposure to risk is more an aspect of the design and successful implementation of adjustment programs than large use by a few countries. Therefore, considerations of Fund credit concentration should not deter the desired action to slow the pace of reserve accumulation..

In judging the Fund's exposure to credit risk, the staff are of the view that the impact of the potential depletion of precautionary balances associated with compulsory withdrawal of a member from the Fund and the use of GRA resources in financing the interim ESAF should also be taken into account. But, in this regard, it has to be noted that these circumstances may or may not arise. We consider the case of compulsory withdrawal of the country in question as unlikely, as we have full trust in the authorities' determination, given the sympathetic support of the international financial community, including the Fund, to find a solution to the arrears problem.

As regards the interim ESAF, no final decision has so far been made that GRA resources would be used for the purpose. Moreover, we doubt whether purchases of GRA resources by ESAF-eligible members would pose an additional risk that differs greatly from that of other users of Fund credit. It would, therefore, appear appropriate to delay any buildup of precautionary balances for these purposes.

Turning to the other issues, on burden sharing, we fully agree with the staff that, under the circumstances, it is reasonable to maintain for FY 1998 the burden sharing of deferred charges and of contributions to SCA-1. As the accumulation of resources in the SCA-2 has now reached the target of

SDR 1 billion, it appears that there is no need for further balances to be accumulated in that account.

We support that any net income for FY 1998 in excess of the target be refunded through a retroactive reduction in the rate of change for that year, and any shortfall be reflected in an increase of the net income target for FY 1999, as shown in Decision No. 3.

As regards special charges, we fully concur with the staff's view that they be discontinued. It is clear that the system does not adequately meet either of its initial objectives. The cost of administering the system exceeds the amounts collected from these charges, and there is little indication that the system itself is effective in avoiding the occurrence of arrears.

Mr. Barro Chambrier made the following statement:

At the outset let me say that I share Mr. Mirakhor's view that we should not push too far the analogy in considering the fund as a commercial bank. I also consider like Mr. Wijnholds that providing concessional loans has served well the purpose of our Institution. Having said that, I welcome this opportunity to review the updated staff projections of the Fund's income position and related issues for FY 1997 and FY 1998. In particular, as regards the income position, I note that its level is projected to be beyond expectations, compared to the projections made at midyear. Therefore, if the envisaged trend can materialize, this chair can support the use of any excess amount of income to reduce retroactively the rate of charges.

As regards burden sharing, I continue to believe that the current burden sharing decision remains appropriate, which clearly underlines that the cost of deferred charges and of financing the SCA-1 is shared equally between creditors and debtors, particularly when a member is in protracted arrears to the Fund. As long as there will be cases of protracted arrears to the Fund, and taking into account the potential impact that the cost of overdue obligations could have on Fund's income position and on the rate of charges, I can go along with the staff proposal for burden sharing of deferred charges and of contributions to SCA-1 to be extended in FY 1998. This extension could also be justified by similarity with the recent Board's decision to extend for one more year the Right accumulation program. Also, I would be inclined to keep the present rate of accumulation in the SCA-1, in light of the factors well identified in the staff report. I am also pleased to learn from the staff report that the accumulation of resources in the SCA-2 is expected to reach the target of SDR 1 billion at the end of the FY 1997. After reaching this target, although it is assumed that a decision to terminate the SCA-2 would reduce the overall level of the Fund's precautionary balances, I can agree that any Fund's exposure to risk be covered by other precautionary balances.

Regarding the Fund's precautionary balances, it is encouraging to note that its level has continued to improve. I also appreciate the relevant factors identified in the paper regarding the adequacy of the precautionary balances, qualitative as well as quantitative ones. With respect to the Fund's precautionary balances, although it is assumed that no new cases of protracted arrears will be registered for FY 1998, this chair shares the view that, despite the level already reached, consideration should continue to be given to the maintenance of the present pace of their accumulation for FY 1998, particularly as a safety net, given the uncertainties surrounding the volatile and changing international environment. With regard to the Fund's exposure to risk, I would like to emphasize that the best guarantees for Fund resources should remain the strength of the adjustment programs and the strengthened cooperative strategy on overdue financial obligations to the Fund formulated in early 1990.

Concerning the present system of special charges, I have no difficulty to support the staff's suggestion as regards its abolishment.

Mr. Prader made the following statement:

At this stage, and in the absence of better alternatives, I am in favor of maintaining the status quo, that is, an unchanged income target of 5 percent and an unchanged rate of accumulation of precautionary balances. The interests of debtors and creditors alike are best served by maintaining a conservative, nondiscretionary approach. The current approach offers protection to debtors from erratic and periodic proposals by some shareholders to raise the rate of reserve accumulation.

A closer assessment of Mr. Newman's proposal would have educational value, but it would likely show that the Fund should be compared with a central bank, rather with a commercial bank.

Mr. Fayolle made the following statement:

Like Mr. Prader, I will limit my comments for the current discussion.

I take note of the staff's position that the current level of precautionary balances might justify a reduction of the net income target from 5 percent to 3 percent of reserves, and I agree with Mr. Yoshimura that there are good reasons to envisage a lower pace of reserve accumulation in the future. At the same time, however, I am not convinced of the urgency to take such a decision at the present stage. As this chair has indicated on previous occasions, we would be comfortable in agreeing to a reduction in the net income target, if a parallel understanding could be reached on the need to introduce special safeguards for countries with very large amounts of access to Fund resources. However, the two-point reduction in the net income target proposed by the staff is too ambitious.

Mr. Phan made the following statement:

The staff paper and its update are very informative, although I do tend to find it very technical in some aspects.

While I welcome the better than expected outturn for the Fund's income position, I note also that this is due to the factors which are not likely to reoccur in the coming financial year. Bearing this in mind, I would conservatively support a continued net income target of 5 percent of reserves under Decision 3, implying a necessary coefficient of rate of charge of 109.6 percent of the SDR interest rate.

The Fund's precautionary balances have continued to strengthen over the financial year, and the SCA-2 has reached its targeted amount of SDR 1 billion. Notwithstanding this, we share the staff's concerns on the uncertainties posed by the possible liquidation of SCA-2 resources, the potential depletion of precautionary balances in connection with the compulsory withdrawal of a member, and the use of GRA resources in financing the interim ESAF. Thus we support Decision 1 on the continuation of the Burden Sharing arrangement, and the further accumulation of balances in the SCA-1.

We also support Decision 2 on the SCA-2, and Decision 4 on the disposition of net income for financial year 1997.

On Decision 5 regarding special charges, we will support the majority decision over the question of its abolition.

Mr. Waterman made the following statement:

I agree with many of Mr. Newman's comments on out general approach to financing the Fund and that the current policy is complex and not sufficiently transparent or equitable. We would not rule out changes to the system, including the introduction of a uniform adjustable norm, if sufficient support for that could be gathered.

It is clear that the Fund's reserve position has strengthened over the past year, but there are some other factors that need to be taken into account, including the liquidation of the SCA-2, the position of Sudan, the general tendency toward increased concentration of Fund lending to a few members with large amounts of access, and the possible use of GRA resources to finance the interim ESAF. Taking into account those uncertainties, I could go along with a reduction of the net income target from 5 percent to 4 percent of reserves. However, if the choice is between 5 percent and 3 percent, I would be inclined to maintain the current net income target of 5 percent for the time being.

I would prefer to maintain the current burden-sharing mechanism and the current rate of accumulation of reserves in SCA-1.

I do not have strong views on the question of special charges. However, I would be inclined to keep the present system for the time being, for the reasons given by other speakers.

Mr. Cippa made the following statement:

It is encouraging to note that the net income for FY 1997 is estimated to be higher than the net income target for that year allowing a retroactive reduction of the rate of charge. As expected, SCA-2 reached the target of SDR 1 billion in the fourth quarter of FY 1997, requiring no further accumulation in that account.

Because total credit outstanding has declined in FY 1997, precautionary balances as a proportion of total credit outstanding have increased from 9.7 to 10.8 percent. However, had Mexico not done the unexpected early repurchase and not abstained from drawing the last tranche of its Stand-By Arrangement, the ratio would have been 10.2 percent. This underscores once again the high margin of uncertainties the projections of such ratios are connected with. Furthermore, the ratio is still below the 1994 peak.

Let me say that I share most of the comments made by Mr. Donecker and Ms. Srejber, especially in linking reserves with outstanding credits. For the time being, we do not support a reduced pace of accumulation of the Fund's precautionary balances. This would result in a net income target for FY 1998 of 5 percent of the Fund's reserves and an accumulation of SCA-1 also of 5 percent to be borne by debtor and creditors. Our cautious attitude is based on factors already mentioned by previous speakers, namely that: Credit concentration is still very high. Outstanding purchases by the largest and the three largest debtor members represent approximately 30 and 60 percent, respectively, of total credit outstanding by end FY 1997. This concentration is not expected to change significantly during the next financial year. Credit to members with programs that are off track increased from 4 to 36 percent. Although this is largely affected by one member, this is nevertheless a worrisome development. A number of decisions are likely to be taken within FY 1998 which could reduce the risk cover of outstanding credit. Firstly, a decision to finance the interim ESAF could increase the level of outstanding Fund credit and, consequently, the Fund's exposure to risk. Secondly, SCA-2 resources might be used to finance bilateral contributions to the HIPC Initiative which would reduce the level of precautionary balances. Thirdly, if Sudan was requested to withdraw in FY 1998, SCA-1 would sharply be reduced. Finally, any decision to sell a part of the Fund's gold holdings would lead to a reduction of available real reserve.

On burden sharing, we support the continuation of the present mechanism.

Finally on special charges, we note that the present system does not necessarily cover the system's administrative costs. We hesitate, however, to support an abolition of the present system. Special charges set an incentive for members not to become overdue. Giving up such an incentive might have adverse signal effects. Sending such signal effects should especially be avoided at a time we are discussing the HIPC Initiative. Nevertheless, we are willing to consider modifications if they can save administrative costs of handling the system.

Mr. Kannan said that his chair could support a reduction of the net income target to 3 percent of reserves at the beginning of FY 1998 and a continuation of the current burden-sharing arrangement. His chair could also support the staff proposal for abolishing the system of special charges.

Mr. Mirakhor stated that he could associate himself with the comments put forward by Mr. Vernikov for the current discussion. He welcomed the willingness expressed by some chairs, such as that of Mr. Yoshimura, to consider slowing the rate of accumulation of the Fund's precautionary balances through a reduction of the net income target. Although it was regrettable that some chairs did not consider such a reduction appropriate at the present stage, it was to be hoped that the Board would return to that issue in the near future.

Mr. O'Loghlin commented that his chair would prefer to retain the present rate of accumulation of precautionary balances, with a net income target of 5 percent of reserves at the beginning of FY 1998. His chair would also prefer to retain the current burden-sharing mechanism. Although the position of his chair was somewhat flexible with respect to the system of special charges, it would have no difficulty agreeing to retain the current system.

Mr. Newman noted that, in his opening statement, he had not commented on the decisions currently under consideration. As he had indicated, his preference would have been to embark on a thorough review of the processes for determining the Fund's income position, precautionary balances, and burden sharing in order to make them more transparent and equitable. Indeed, many of the views expressed by Directors for the current discussion had been based as much on who would be required to contribute to financing the Fund as on the extent to which the Fund's financial position was adequate. That consideration may have been behind Mr. Mirakhor's suggestion that the net income target be reduced at the present stage, and raised again in the future should a clear need arise. As any future decision to increase the Fund's net income target would require a majority of 70 percent of the votes in the Fund, it might be difficult to effect such an increase quickly.

If the Board had concluded that the Fund's precautionary balances were adequate, his chair could have supported a decision to reduce the burden-sharing contributions to SCA-1 by about 1 percent, as that would have represented the most financially neutral—in terms of the contributions made by debtors and creditors—way to reduce the rate of accumulation of the Fund's precautionary balances, Mr. Newman stated. As such a proposal was not currently under consideration, his chair would support maintaining the status quo.

The Deputy Treasurer noted that the staff paper was not intended to favor a reduction in the rate of accumulation of the Fund's precautionary balances. The staff position was neutral with respect to the adequacy of precautionary balances, which was largely a matter of judgment. If, however, the rate of accumulation of precautionary balances was to be slowed, it might be preferable to achieve such a slowdown through a reduction of the net income target rather than through a reduction in the rate of accumulation of balances in the SCA-1. In coming to a decision on how to reduce the Fund's precautionary balances, it would be important to take into account the fact that the primary purpose of the Fund's precautionary balances was to protect it against any losses that it might incur in the event that members did not make prompt repayments. That was also the primary purpose of SCA-1. In contrast, the Fund's reserves, which served a broader purpose, might be considered appropriate. In addition, SCA-1 was more flexible in terms of its administration, because excess resources in the SCA-1 were refundable when no longer needed, whereas additions to the Fund's reserves were permanent. The resources of the SCA-1 had not yet attained such a level that they would, themselves, protect the Fund's financial position against all risks that could arise from members falling into protracted arrears.

The interesting suggestions put forward by Mr. Newman required careful and thorough analysis, as on first sight they seemed to imply radical changes in the current policies and processes used to determine the Fund's income position, precautionary balances, and burden sharing, the Deputy Treasurer considered. While the Fund's current policies had been designed to cover the Fund's operational and administrative costs through the rate of charge and other resources available to the Fund, the proposal would appear to result in a system under which the Fund's income position would be determined by the differential between short-term SDR interest rates and a calculated five-year SDR interest rate. Although it might be reasonable to expect the medium-term SDR interest rate to exceed the short-term SDR interest rate, the reverse could also occur. Questions would also arise concerning how the Fund would wish to accommodate unexpectedly high levels of income generated under such a system. For example, preliminary calculations showed that the use of a uniform adjustment norm in 1997 would have resulted in a net income position of about SDR 500 million.

Mr. Newman remarked that income generated under the system outlined in his statement could be used to cover the administrative expenses of the Fund as well as its operational costs and the accumulation of precautionary balances. Such a system would be far more transparent than the current policies employed by the Fund.

The Deputy Treasurer noted that the staff's estimate of a net income position of SDR 500 million had taken into account administrative costs.

With respect to the decision on the net income target and the rate of charge on the use of Fund resources in FY 1998, it should be noted that, in the event that the Fund's net income for FY 1998 fell short of the targeted amount, the rate of charge could not be increased retroactively, the Deputy Treasurer said. Therefore, in the past, the Board had agreed that any shortfall should be recouped in the subsequent year. However, the necessary increase in the rate of charge would require a decision by the Board.

The question of whether special charges should be set as a portion of the rate of charge had been examined by the Board on previous occasions, the Deputy Treasurer recalled. A determination had been made that it would not be appropriate, from a legal perspective, to set special charges in such a manner.

Mr. Guzmán-Calafell asked whether the staff could comment on the possible use of GRA resources to finance an interim ESAF. At the present stage, it was not clear what amount of resources would likely be involved or what the timing of disbursements might be. He wondered whether the staff considered that the uncertainties related to the possible use of GRA resources to finance an interim ESAF could be seen as legitimate grounds for maintaining the present pace of accumulation of the Fund's reserves.

With respect to the resources of the SCA-2, it was his understanding that the balances remaining from the use of the rights approach were related to only one country, Mr. Guzmán-Calafell said. Therefore, he wondered whether the staff could comment on whether it would be appropriate to assume that the balances outstanding for that country suggested that the Fund should continue to build reserves beyond those that would normally be accumulated for any other country.

The Deputy Treasurer remembered that on several previous occasions the Board had considered that it would not be appropriate to base decisions on the Fund's net income target and precautionary balances on credit outstanding to a particular country. Indeed, there was no reason to believe that any particular country was likely to fall into arrears. For that reason, the staff tended to base its assessments and recommendations on the total amount of credit outstanding in general, but with particular attention to the amounts of credit outstanding to members already in arrears.

The total amount of credit outstanding under the rights approach presently was about SDR 650 million, which was covered by the resources of the SCA-2, the Deputy Treasurer said. However, in the event that the SCA-2 was abolished, that amount of credit would need to be covered by the Fund's other precautionary balances.

In the event that the resources of the GRA were used to finance the interim ESAF, the amounts of credit outstanding in the GRA would increase, the Deputy Treasurer stated. The precise demands on the Fund's resources emanating from the interim ESAF were not yet clear. However, to the extent that the amount of credit outstanding rose, it would need to be covered by the Fund's precautionary balances. Thus, any increase in credit outstanding would impact on the extent to which the Fund's precautionary balances could be seen as fully adequate. On previous occasions, several Directors had expressed the view that the Fund tended to be backward looking, in that it set the rate of accumulation of its precautionary balances on the basis of the amount of credit already outstanding, and had suggested that projected future extensional credit also be taken into account.

The Secretary noted that the special majority required for the decision on the implementation of burden sharing in FY 1998 had been obtained, as well as the simple majority required to complete the review of extended burden sharing. The decision on the net income target and the rate of charge on the use of Fund resources for FY 1998 contained three elements, the Secretary said. With respect to the first element of that decision, namely, on the net income target for FY 1998, Directors holding the required majority of 70 percent of the total voting power had expressed support for a net income target of 5 percent of the Fund's reserves at the beginning of FY 1998. As to the second element on the rate of charge, the proportion of the rate of charge referred to in Rule I-6(4) to the SDR interest rate under Rule T-1 would be 109.6 percent. The majority needed to support the third element of that decision, providing for a possible retroactive reduction of the proportion of the rate of charge to the SDR interest rate for FY 1998, had also been achieved.

Owing to the linkage between the decisions on the Fund's rate of charge and on the Fund's administrative budget, which had not yet come into effect, it should be noted that the decision on the rate of charge on the use of Fund resources for FY 1998 would become effective upon the effectiveness of the decision on the administrative budget, the Secretary commented.

The simple majority required for the adoption of the proposed decision relating to the disposition of net income for FY 1997 had been met, the Secretary stated.

Finally, with respect to the alternative decisions that had been presented on special charges, Directors holding a simple majority of the votes cast had favored maintaining the current system of special charges and completing the review, the Secretary noted. The alternative decision presented, which would have provided for the discontinuation of special charges, required a majority of 70 percent of the total voting power, and had not garnered the necessary support.

The Acting Chairman said that the suggestions put forward by Mr. Newman and other Directors could be taken up for further consideration in the future.

The Executive Board took the following decisions:

Income Position—Burden Sharing—Implementation in FY 1998

Section I. Principles of "Burden Sharing"

1. The financial consequences for the Fund which stem from the existence of overdue financial obligations shall be shared between debtor and creditor member countries.

2. The sharing shall be applied in a simultaneous and symmetrical fashion.

Section II. Determination of the Rate of Charge

1. The rate of charge for financial year 1998 referred to in Rule I-6(4) shall be adjusted in accordance with the provisions of Section IV.

2. When estimating income for purposes of Rule I-4(4)(a) and (b), no projection shall be made of deferred income. The calculation of actual net income under Rule I-6(4)(b) shall include the proceeds of adjustments for deferred income under Section IV, paragraph 2.

Section III. Amount for Special Contingent Account I

An amount equivalent to 5 percent of the Fund's reserves at the beginning of the financial year shall be generated during financial year 1998 in accordance with the provisions of Section IV, and shall be placed to the Special Contingent Account-1 referred to in Decision No. 9471-(90/98), adopted June 20, 1990.

Section IV. Implementation of Burden Sharing

1. During financial year 1998, notwithstanding Rule I-6(4)(a) and (b) and Rule I-10, the rate of charge referred to in Rule I-6(4) and the rate of remuneration prescribed in Rule I-10 shall be adjusted in accordance with the provisions of this Section.

2. (a) In order to generate the amount to be placed to the Special Contingent Account-1 in accordance with Section III, the rate of charge, and,

subject to the limitation in (c), the rate of remuneration, shall be adjusted in accordance with the provisions of this paragraph, so as to produce equal amounts of income.

(b) If income from charges becomes deferred during an adjustment period as defined in (d), the rate of charge and, subject to the limitation in (c), the rate of remuneration, shall be further adjusted, in accordance with the provisions of this paragraph, so as to generate, in equal amounts, an additional amount of income equal to the amount of deferred charges. For the purposes of this provision, special charges on overdue financial obligations under Decision No. 8165-(85/189) G/TR, adopted December 30, 1985, as amended, shall not be taken into account.

(c) No adjustment in the rate of remuneration under this paragraph shall be carried to the point where the average remuneration coefficient would be reduced below 85 percent for an adjustment period.

(d) The adjustments under this paragraph shall be made as of May 1, 1997, August 1, 1997, November 1, 1997, and February 1, 1998: shortly after July 31 for the period May 1 to July 31; shortly after October 31 for the period from August 1 to October 31; shortly after January 31 for the period from November 1 to January 31; shortly after April 30 for the period from February 1 to April 30;

(e) The operation of this decision shall be reviewed when the adjustment in the rate of remuneration reduces the remuneration coefficient to the limit in (c) above.

3. (a) Subject to paragraph 3 of Decision No. 8780-(88/12), adopted January 29, 1988, the balances held in the Special Contingent Account-1 shall be distributed in accordance with the provisions of this paragraph to members that have paid additional charges or have received reduced remuneration as a result of the adjustment, when there are no outstanding overdue charges and repurchases, or at such earlier time as the Fund may decide.

(b) An amount equal to the proceeds of any adjustment for deferred charges shall be distributed, in accordance with the provisions of this paragraph, to members that have paid additional charges or have received reduced remuneration, when, and to the extent that, charges, the deferral of which had given rise to the same adjustment, are paid to the Fund. Distributions under this provision shall be made quarterly.

(c) Distributions under (a) or (b) shall be made in proportion to the amounts that have been paid or have not been received by each member as a result of the respective adjustments.

(d) If a member that is entitled to a payment under this paragraph has any overdue obligation to the Fund in the General Department at the time of payment, the member's claim under this paragraph shall be set off against the Fund's claim in accordance with Decision No. 8271-(86/74), adopted April 30, 1986, or any subsequent decision of the Fund.

(e) Subject to paragraph 4 of Decision No. 8780-(88/12), adopted January 29, 1988, if any loss is charged against the Special Contingent Account-1, it shall be recorded in accordance with the principles of proportionality set forth in (c).

Decision No. 11480-(97/42), adopted
April 21, 1997

Income Position—Extended Burden Sharing—Review

The Fund has reviewed the operation of Decision No. 9471-(90/98), adopted June 20, 1990, as amended.

Decision No. 11481-(97/42), adopted
April 21, 1997

Income Position—Net Income Target and Rate of Charge on Use of Fund Resources for FY 1998

1. The target amount of net income for FY 1998 shall be 5 percent of the Fund's reserves at the beginning of the financial year.

2. Effective May 1, 1997, the proportion of the rate of charge referred to in Rule I-6(4) to the SDR interest rate under Rule T-1 shall be 109.6 percent.

3. Any net income for financial year 1998 in excess of the target amount of net income of 5 percent of the Fund's reserves at the beginning of that financial year shall be used to reduce retroactively the proportion of the rate of charge to the SDR interest rate for financial year 1998. If net income for financial year 1998 is below the target amount for that year, the net income target for financial year 1999 shall be increased by the equivalent of that shortfall.

Decision No. 11482-(97/42), adopted
April 21, 1997

Income Position—Disposition of Net Income for FY 1997

The Fund's net income for financial year 1997, up to SDR 93,793,653, shall be placed to the Special Reserve after the end of the financial year.

Decision No. 11483-(97/42), adopted
April 21, 1997

Overdue Financial Obligations—Special Charges—Review

The Fund has reviewed the system of special charges applicable to overdue obligations to the General Resources Account, the Structural Adjustment Facility, and the Trust Fund.

Decision No. 11484-(97/42) G/SAF/TR, adopted April 21, 1997

2. REPUBLIC OF YEMEN—STAND-BY ARRANGEMENT—REVIEW, MODIFICATION, AND WAIVER OF PERFORMANCE CRITERIA

The Executive Directors considered a staff paper on the second review under the 15-month Stand-By Arrangement for the Republic of Yemen approved on March 20, 1996 and Yemen's request for a waiver of performance criteria (EBS/97/54, 3/31/97)

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

This statement summarizes information on the Republic of Yemen which has become available since the staff report (EBS/97/54) was circulated to the Executive Board on March 31. The information does not change the thrust of the staff appraisal.

The Yemeni authorities have confirmed that, following the appointment of judges by a Presidential decree issued on March 25, the special courts for loan contract enforcement became effectively operational at end-March—thereby implementing the prior action for the first review.

Progress has been made in implementing the measures targeted for early 1997 in the authorities' supplementary letter of intent:

On March 9, the Minister of Finance issued the regulations governing the cigarette stamp tax system. The system is expected to become operational in June.

The government has prepared a draft paper outlining the reform program intended for the major public sector pension fund based on the recommendations of the Fund's Fiscal Affairs Department. The program is under discussion within the government and is expected to be submitted for Cabinet approval by midyear.

On April 2, the central bank instructed all commercial banks to begin reporting their loans with a face value of at least YRls 10 million (about $80,000) that have been nonperforming over the previous six months. This requirement will provide the database for implementing the notification list system regarding nonperforming assets.

The authorities have confirmed that the program for compilation and reconciliation of the nonperforming public enterprise loans at the public sector commercial banks has been virtually completed.

The authorities' continued tight demand management policies have contributed to a further sharp deceleration of inflation. By March 1997, the year-over-year consumer price index inflation rate amounted to less than 4 percent—which is also equivalent to the core inflation rate in this case. Under these circumstances, the authorities intend to implement the second monetary reform package—which would encompass a further interest rate reduction—after the late April parliamentary elections.

With the low inflation, the free market exchange rate remained stable over January–April at about YRls 125 per $1 on average. In January, central bank own gross foreign exchange reserves increased further to $1 billion (4.5 months of projected 1997 imports).

The staff representative from the Legal Department noted that a correction to the proposed decision in EBS/97/54 had been circulated to Directors. It had been necessary to correct a reference to the first review contained in the original draft decision, as this was the second review of the Republic of Yemen's Stand-By Arrangement. A correction was also needed to take into account the delay in the timing of the current review, which had given rise to a request for a waiver of applicability of performance criteria, so that the Republic of Yemen could make the purchases available to it under the Stand-By Arrangement.

Mr. Shaalan made the following statement:

The Yemeni authorities have continued to successfully implement the ambitious reform program, that was initiated in 1995 and supported by a Fund Stand-By Arrangement in 1996, in a comprehensive and determined manner. The second program review indicates that policy outcomes have exceeded program expectations with a stronger fiscal outcome, reduced government debt, and lower broad money growth than programmed. Based on this steadfast implementation of reforms, and aided by more favorable oil prices, macroeconomic performance also exceeded program expectations. Average inflation is well below the program target and core inflation fell to nearly 10 percent. At the same time, real nonoil GDP is estimated to have increased by 4 percent for the year. The current account deficit was less than 1 percent of GDP compared to a programmed 3.5 percent. Prudent management of the oil revenue windfall helped to raise gross foreign exchange reserves to well above the program target. The accomplishments, by any standard, constitute a success story.

As envisaged under the program, significant fiscal consolidation has been the centerpiece of the stabilization effort in 1996. Following a deficit exceeding 16 percent of GDP in 1994 and 6 percent in 1995, the overall budget cash deficit was reduced to 2.5 percent—a level lower than programmed. Both revenues and expenditures contributed to this outcome. It is particularly noteworthy that government revenues were 6.6 percentage points of GDP higher than projected under the program, reaching three times their 1994 level. Non-oil revenues increased markedly as a result of the fundamental reform of the tax system, particularly the excise and corporate profit tax systems. Total expenditures while exceeding the program target were marked by an improvement in expenditure composition. While the sudden surge in oil and wheat prices were largely responsible for raising explicit subsidy payments (and for the consequent breach of the end-1996 ceiling on primary nondevelopment expenditures), the authorities moved to offset them through cuts in other current expenditures, most notably defense and wages—despite difficult social conditions. Together, civilian wages and defense expenditures were reduced by nearly 3 percent of GDP in 1996. At the same time, development expenditures were increased by about 4 percentage points of GDP with the resumption of some earlier suspended investment projects and provision of badly needed rehabilitation in flood-damaged areas. Public sector savings improved remarkably by 6.5 percentage points of GDP compared to 1995 and turned positive in 1996. This strong fiscal performance, and successful introduction of government debt instruments, made it possible to effect a significant reduction in the stock of debt to the banking system.

Progress was made in civil service retrenchment, even though the numbers fell short of the authorities' projections. Clearly, the degree of administrative and legislative obstacles to be overcome was underestimated as was the inadequacy of pension payment schemes. The authorities are committed to continue their retrenchment program in 1997 with the aim of realizing the reductions projected for 1996 in the context of a wider civil service reform program under the proposed ESAF.

The benefits of prudent monetary and exchange rate policies became evident in the second half of 1996. Unification of the exchange rate in July, significant increases in interest rates to positive levels, and the deceleration of core inflation resulted in enhanced confidence in the rial as evidenced in a decline in currency in circulation and a sizable increase in quasi-money. Tight financial conditions, in turn, supported the stability of the exchange rate which remained within a narrow band since July. Progress on the inflation front allowed the central bank to introduce a package of measures to ease monetary conditions. These included reduction of the benchmark deposit rate structure, lowering legal reserve requirements, and remuneration of rial-denominated reserves. One-year treasury bills were also introduced last January in order to absorb the excess liquidity stemming from these measures.

The Republic of Yemen continues to maintain a liberal trade regime since the full implementation of comprehensive reforms in 1995. In December 1996, The Republic of Yemen accepted Fund obligations under Article VIII. While important strides were made toward normalizing relations with external creditors in 1996, a planned Paris Club meeting did not take place until September 1996, making it difficult for The Republic of Yemen to clear external payments arrears by end-1996. Arrears clearance is now projected by end-June 1997.

In order to promote private sector activity and improve social conditions, the authorities have implemented a number of far-reaching structural reforms during 1996. Besides the important structural reforms in the fiscal, monetary, and exchange areas which were noted above, the government initiated an ambitious privatization program and a more transparent privatization law has been sent to Parliament for approval. A package of regulatory reforms was implemented to remove obstacles to private investment including elimination of licensing requirements, municipal clearances, and some ministerial clearances. The operation of the special courts for loan contract enforcement, which was delayed due to unforeseen procedural difficulties, commenced in March 1997.

For 1997, the reform program calls for continued steadfast implementation of tight financial policies and strong structural reforms aimed at achieving a higher nonoil growth rate of 5.5 percent of GDP and a further reduction of core inflation to 7.5 percent of GDP. Fiscal restraint will continue with the budget deficit targeted to remain at its 1996 level while public sector savings are expected to increase further in 1997 allowing for higher public and private investments. Further improvements in the budget structure are envisaged. Revenue mobilization is to be strengthened through additional reforms in excise and personal income taxation, customs administration, and through intensifying preparations for adoption of the general sales tax. Energy price adjustments, changes in wheat procurement systems, and a cash transfer program to compensate the poor for the loss of income will make it possible to eliminate the energy subsidies by end-1998 and wheat subsidies by end-2000. Reductions in subsidies, as well as restraint in wage and defense expenditures, will allow for a redirection of public resources toward operations and maintenance, particularly in the areas of health, education, and agricultural extension services without increasing the overall level of expenditures. More effective infrastructure and social programs are to be achieved via careful evaluation of economic returns on public investment projects, civil service retrenchment and implementation of a number of better targeted social safety net programs.

Once more, there will be no recourse to bank financing of government operations allowing for the expected increase in credit to the nongovernment sector following improvement in the investment environment and effective operation of the special courts. A second package of monetary and banking reform measures is also being implemented to enhance the use of indirect monetary control instruments and to ease monetary conditions to some extent. Simultaneously, a financial sector reform program is being formulated, with World Bank assistance, aimed at enhancing financial intermediation functions.

The Republic of Yemen will continue to require substantial external financing not only in order to meet its external deficit, but also in order to eliminate arrears outstanding at end-1996 amounting to some $6 billion. Following the September Paris Club meeting whereby debt relief for the first half of 1997 was secured, negotiations are under way with most of the Paris Club and non–Paris Club bilateral creditors for debt relief of obligations due in the second half of 1997. Debt buyback agreements are being worked out with eight major commercial bank creditors. Discussions are also under way with the Russian Federation and the authorities hope to reach agreement by the middle of the year. The authorities hope to partly cover the residual gap from the proposed ESAF arrangement and from new bilateral and multilateral resources. In this regard, the Yemeni authorities wish to acknowledge the efforts of the government of the Netherlands in co-hosting the upcoming Second Consultative Group meeting in June 1997.

In concluding, allow me to reiterate the firm commitment of the authorities to deepening the reform efforts by expanding on their remarkable achievements thus far. They are intent on continuing the implementation of their ambitious adjustment and structural reform program under an ESAF arrangement. The authorities' strong resolve, outstanding track record, and unwavering commitment to reform deserve the full support of the international community. Finally, I join the authorities in expressing deep appreciation for the staff's tireless and industrious efforts during program discussions and in the provision of technical assistance to the Republic of Yemen.

Mr. Schneider, speaking on behalf of Ms. Lissakers, made the following statement:

I want to commend the Yemeni authorities for the strong progress they have made during the past year. There have certainly been problems and unexpected difficulties, but I remain impressed with the authorities' continued commitment to the reform process and flexibility in addressing deficiencies as they arise. This is the kind of determination that we will be looking for in the design of an ESAF-supported program.

Despite lower growth this year, there is much to be encouraged by. Tight fiscal and monetary policies have again succeeded in virtually halving core inflation to 11 percent. Non-oil revenues continued to rise and exceeded targets at 10.7 percent of GDP, and some windfalls generated by higher than expected oil revenues and excess cost recovery payments allowed for a badly needed expansion of development expenditures without jeopardizing the overall fiscal balance. The stability of the exchange rate following the July 1 exchange system unification was surprising, but certainly welcome. I think the Fund has been right to push for this measure as another means to maintain stability in the face of external shocks.

Despite these positive developments, however, the Yemeni economy continues to be vulnerable and subject to a precarious balance of payments situation that can only be resolved through a combination of debt rescheduling and a fundamental reorientation of the economy toward private sector growth. As to the first issue, some solid progress has been made on Paris Club debt with the debt relief granted on Naples terms. Given that we may be considering an ESAF arrangement later this year, however, I would appreciate an update from staff on the status of the Republic of Yemen's negotiations on non–Paris Club debt which, as pointed out in the staff paper, constitutes the bulk of reschedulable debt.

The reorientation of the economy from a planned to a market system will require consistent implementation by the authorities. I want to reemphasize that the progress we have seen over the past couple of years is a good start on this road. However, what we are seeking to achieve in Fund programs is to put economies on a different track—one that will lead to sustainable growth and away from the need to seek multilateral assistance. This point is particularly important given the Republic of Yemen's expressed desire to enter into an ESAF-supported program, where conditionality will be all that much tighter and we will be reluctant to grant the kind of nonperformance waivers we see before us today.

In this context, let me make a few points about performance over the past year and the medium-term outlook. On fiscal policy there were a number of significant points. First, the variances in current expenditures resulting from higher than expected prices for petroleum product and wheat prices highlight the inefficiencies of using subsidies as a means of poverty alleviation. I was glad to see that authorities have reaffirmed their commitment to eliminate these subsidies by 1999 and 2001, respectively, in favor of an enhanced social safety net. I was struck, however, by the slow progress on implementing initiatives, such as the Social Welfare Fund and the public works program. Acceleration of these initiatives will clearly be necessary if the elimination of public subsidies is not to adversely affect low income groups.

On the issue of clearing energy sector arrears, I welcome the progress that the authorities have made in identifying these arrears—equal to about 0.5 percent of GDP—and in establishing a more regular framework for payments and review of state accounts. I would like to ask the staff whether they are satisfied with this arrangement, however, and whether the authorities should not establish penalties for arrears.

Further on expenditures, the failure to complete programmed retrenchments in the civil service was disappointing, although we recognize that part of this has to do with the current legal framework. We note authorities' interest in pursuing a wide-ranging civil service reform under an ESAF-supported program, and I think it important to underscore that retrenchments planned for 1996 should be completed before an ESAF arrangement is approved. Also, we would expect that under an ESAF arrangement, the elimination of current legal restraints on layoffs would be eliminated. Perhaps staff could explain whether such changes would have to go through parliament. In the meantime, holding general wage increases to 10 percent and limiting military expenditures seems warranted given the halting progress on reducing government subsidies.

On monetary policy, structural and macroeconomic policies are closely related and must proceed in step. One of the linchpin structural issues is the operation of special courts for loan contract enforcement. This chair has emphasized in the past the importance of establishing these courts as part of Yemen's transition to a market-based system. The reluctance of banks to undertake lending operations in the absence of these courts underlines the point that you really cannot make the transition to a commercial-credit-based system without a means of enforcing contracts. Thus, the delay in establishing these courts has been a genuine concern, and I welcome the notice in the staff supplement that these courts have finally become operational. The effective operation of these courts also seems important in the context of authorities' plans to further reduce the benchmark deposit rate, allow the use of foreign currency deposits as collateral for local currency loans, and free up bank fees and charges later this month. The resulting expansion in credit to the nongovernment sector—which will hopefully add some fuel to the privatization process—will depend on the effective operation of the contract enforcement courts. Finally, I welcome the authorities' determination to establish a reserve money program and shift to indirect monetary policy tools.

Noted in the staff report were the difficulties that authorities encountered in the area of enterprise reform and privatization. I have several questions in this regard. First, regarding authorities' efforts to streamline the privatization process with a new privatization law, given the delays we have seen in other areas stemming from parliamentary approval, is this law also likely to be held up? Second, noting cooperation with the World Bank to prepare a package aimed at promoting private sector investment, I saw that "elimination of municipal clearances" was included as one of the measures. Were these "municipal clearances" at issue in delaying projects under the government's public works program, and can such clearances be eliminated without considerable political opposition? Finally, I was disappointed to see that initiatives to grant public enterprises more autonomy ran into delay within the administration. Can the staff update us on where this now stands?

Finally, one element I found missing in the staff report was on the need to diversify exports. Perhaps this has been captured in the 4 percent growth in nonoil GDP, but I would like to hear from staff about any efforts by the authorities to further develop nonoil resources such as coffee and fisheries. I would also like to hear about any plans for the redevelopment and modernization of the port in Aden, which I understand has considerable potential.

With these comments, I can approve completion of the second review and the request for waivers for nonobservance of certain performance criteria.

Mr. Shaalan said that the authorities' commitment to reform was clearly reflected not only in the progress achieved since the Republic of Yemen had entered into a Stand-By Arrangement with the Fund, but also in its overperformance in many key areas. Although, in his opening statement, Mr. Schneider had noted the commitment of the authorities, he seemed to express some disappointment about the authorities' request for waiver of some performance criteria. Therefore, it might be helpful to take into account the nature of, and the circumstances that had led to, the request for waivers.

The proposal on the establishment of commercial courts had given rise to many serious constitutional and social issues in the Republic of Yemen, Mr. Shaalan noted. It had been necessary to resolve those issues, including the questions about interest rates, before the courts could be rendered operational. Despite many difficulties, including with respect to the appointment of appropriate judges, the commercial courts in the Republic of Yemen were now fully operational.

It was common for countries undergoing serious negotiations with non–Paris Club creditors to request waivers on arrears to those creditors while the negotiations were still under way, Mr. Shaalan noted. That was the case for the Republic of Yemen.

The excess in primary nondevelopment expenditures had arisen owing to exogenous and temporary developments, Mr. Shaalan stated. In setting the targets under the program, the staff had used the forecasts in the *World Economic Outlook* for wheat prices. As it turned out, wheat prices had soared well beyond the levels originally expected. In the circumstances, and given the absence of a well-functioning social safety net in the Republic of Yemen, it had been difficult for the authorities to raise domestic prices immediately, especially in light of the unanticipated increase in revenues that had resulted from the increase in petroleum prices. Nevertheless, the actual budget deficit realized for the year as a whole had been 2.5 percent of GDP, compared with the original program target of 3 percent.

Mr. Al-Tuwaijri made the following statement:

> Let me begin by commending both the authorities and the staff for the success in strengthening the Republic of Yemen's economic performance. Over the past year, inflation fell dramatically, the fiscal deficit declined, and external reserves rose. Substantial progress was also made in liberalizing and deregulating the economy.
>
> This encouraging progress notwithstanding, important reforms are still to be completed. Further measures to place the economy on a sustainable high growth path and enhance efficiency top this agenda. In this connection, I look forward to an early agreement on an ESAF-supported program with the Republic of Yemen. Of course, Fund support has commensurate with the strong efforts being undertaken by the Republic of Yemen.
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> I am in broad agreement with the thrust of the staff appraisal and will make few comments for emphasis.
>
> I welcome the substantial improvement in fiscal performance. While oil price developments were an important factor, the authorities' wide ranging reform efforts in the revenue area led to a remarkable increase in nonoil receipts. The commitment to continue with this reform including the announcement of a time table is reassuring.
>
> On the expenditure side, the strong measures that have been implemented and the ongoing reform of the civil service are encouraging. At the same time, however, the higher than programmed current spending highlights the continued vulnerability of the budget to external price shocks. Therefore it is important to adhere closely, and if possible advance the timetable for eliminating subsidies. Efforts are also needed to advance civil service reform.

In the monetary area, I am encouraged by the impressive success in reducing inflation. Indeed, this success should allow for some easing of the monetary stance and, thus help achieve the growth objective. In this regard, the importance of reforming the financial sector cannot be overemphasized. Broadening and deepening financial intermediation will depend to a large extent on strict enforcement of loan contracts. The establishment of the special courts, though a little bit behind schedule, is most encouraging. Enhancing prudential supervision of commercial banks is also of particular importance.

In the external sector, the stability of the exchange rate following unification is reassuring. I am also encouraged by the progress made in normalizing relations with external creditors. Further progress in this area will enhance confidence and encourage investments. Advancing privatization and regulatory reform should also enhance efficiency and private investments. In this regard, the implementation of a number of reforms relating to the General Investment Authority and the approval by the Cabinet of a new privatization law are important steps.

With these remarks, I support the proposed decision, including the requested waivers and wish the authorities continued success.

Mr. Mirakhor made the following statement:

I agree with Mr. Shaalan that the Republic of Yemen's recent accomplishments constitutes "a success story." As he explains in his comprehensive and useful statement, the second program review indicates that program expectations were met or exceeded in all important areas—fiscal, monetary, debt, inflation, and external current account, and gross reserves. The shift to positive real interest rates and the stability of the exchange rate are especially noteworthy as is the welcome pickup in nonoil GDP growth. Against this background of solid progress on the macroeconomic front and the implementation of far-reaching structural reforms, and in view of Mr. Shaalan's explanation of this morning, I have little hesitation in supporting the request for waivers.

The 1997 program is strong, appropriately ambitious, and well balanced; it is deserving of Fund support. It will be important to achieve the higher nonoil GDP growth target and make further progress on reducing inflation. While the concept of the "core" rate of inflation is a useful guide to policy, the headline rate (not specified in the projections for 1997, page 6, Table 2) will probably still be quite high, and efforts should be made to bring it down.

Fiscal and monetary policies have been framed in a prudent fashion. Although the cash deficit ratio is expected to be the same as in 1996, the quality of the budget is better in that reduction in subsidies and containment of the wage and defense bill are contemplated, allowing for a reorientation of expenditures toward high priority items. This accounts for the moderately higher expenditure/GDP ratio. This is a refreshing change from the long-held view that an unrelenting reduction in the deficit and/or expenditure/GDP ratio is always and everywhere a good thing and a sign of progress, irrespective of the quality and composition of the fiscal stance and despite growing empirical evidence that the composition of fiscal spending matters.

Be that as it may, I join the staff in cautioning the authorities against yielding to possible election year spending pressures and/or allowing slippages to develop—particularly with regards to agreed upon pricing measures and subsidy overruns.

I fully support the authorities' all-encompassing and exhaustive agenda on the structural front, but wonder whether the very extensive list of these reforms and the short time span in which they propose to implement it may not overwhelm the country's administrative capacity. I appreciate staff's or Mr. Shaalan's comments.

On the privatization program, I wonder if the staff could elaborate on the proceeds to be used. Also, I would appreciate staff's comments on the safety net available for those already retrenched in the civil service.

I strongly support the authorities' request to move to an ESAF-supported program so as to provide continuity to the reform effort and advance structural reform over the medium term, including in the more sensitive areas of subsidies, civil service reform, and the establishment of a well-targeted cash transfer system.

Finally, we hope that discussions with the Paris Club and other creditors for debt relief of obligations falling due in the second half of 1997 are successful in reducing financing gaps.

With these remarks, I support the revised proposed decision and wish the authorities continued success.

Ms. Kouprianova made the following statement:

The authorities need to be commended for their achievements. Although there were some slippages resulting in nonobservance of three performance criteria, the overall performance was good, and, in many areas, even better than envisaged under the program. While the authorities' commitment to reforms is evident, and their intention to implement an ambitious policy agenda in 1997 is encouraging, a long journey is ahead in putting the country on the rails to high quality growth.

We generally share the thrust of the staff appraisal. Allow me to make a few brief comments on the authorities' policy agenda for 1997.

First, on fiscal policy. The fiscal outcome for 1996, namely the reduction of the overall deficit on a cash basis by more than 4 percentage points to 2.5 percent of GDP, was favorable, especially with respect to the developments on the revenue side of the budget. The better than envisaged outcome was partly due to the trends in oil prices, and to a 2.5 percent of GDP excess cost recovery payment. At the same time, we note the progress achieved in increasing nonoil revenue by 50 percent compared with 1995. These efforts need to be continued in the coming year. We also encourage the authorities to timely implement personal income tax reform, and to introduce a general sales tax at the import and manufacturing stage at the earliest possible date. On the expenditure side, the 1996 outcome has fallen short of expectations, although the reasons for this overshooting are understandable. We concur with the staff in recommending the reduction of subsidies and their eventual elimination in 1998–2000, together with further restraint in defense and wage outlays, and urge the authorities closely to monitor the situation. At the same time, we welcome the increase of development expenditure to 7.3 percent of GDP in 1997, as, for a country such as The Republic of Yemen, investment in rehabilitation of infrastructure will prove crucial to achieve the country's medium-term objectives. In this area, we are encouraged by the fact that the authorities intend to increase the effectiveness of public investment projects, as mentioned in Mr. Shaalan's helpful statement.

Second, on structural policy. The list of measures that need to be implemented in this area is extensive. For 1997, we encourage the authorities to continue privatization and deregulation efforts, and to implement social safety net programs. The delays in civil service retrenchments are a matter of concern. Here, we join Ms. Lissakers in encouraging the authorities to implement envisaged retrenchment measures before the ESAF-supported program is approved. We urge the authorities to speed up formulation of a comprehensive civil service reform program, together with their efforts to undertake custom administration reforms. They also need speedily to formulate and implement a set of measures aimed at financial sector reform in order to develop an adequate financial infrastructure. Generally, given the magnitude of structural measures to be implemented to achieve the authorities' medium-term goals, our view is that the authorities' request for an ESAF-supported program will be appropriate. The program will give the country an opportunity to develop an appropriate base for achieving ambitious medium-term objectives.

Finally we are encouraged by Mr. Shaalan's assurance that his Yemeni authorities hope to reach an agreement with the Russian Federation on the outstanding issues of external indebtedness by mid-1997, as envisaged under the program.

With these remarks, we support the authorities' request to grant waivers for nonobservance of performance criteria, and we endorse the proposed decision. Let me express my authorities' hope that the Republic of Yemen will successfully conclude the current Stand-By Arrangement, and, building upon the reform momentum on the macroeconomic side, will continue with structural transformation efforts.

Mr. Rădulescu made the following statement:

There are several impressive achievements in the policies followed by the authorities in 1996, among which I would emphasize the exchange system unification, together with the formal acceptance of Article VIII provisions, and the increase in deposit interest rates in the banking system to the real positive area. Efforts to privatize public enterprises, to reduce government debt to the central bank and to move toward indirect control instruments in the banking system are also to be commended.

However, I would focus on two issues regarding the fiscal policy, in which progress appears too slow to me: subsidies for petroleum products and wheat, and civil service retrenchment. The former exceeded the program forecast for 1996 by about 40 percent, and represented 14.5 percent of GDP and 38.4 percent of government revenues. While the overage reflected essentially higher than expected world prices for petroleum and wheat, the policy to subsidize consumption itself is counterproductive, has very limited effects on social protection, and eventually leads to slow economic growth. It is striking to see that explicit subsidies for petroleum products equaled in 1996 the badly needed development expenditures, i.e., 6.1 percent of GDP. A rapid shift of governmental expenditures from petroleum products subsidization to infrastructure investment appears extremely desirable, in order to stimulate long lasting growth and better resource allocation. Therefore, I urge the Yemeni authorities to speed up the elimination of energy subsidies and I suggest that this measure be taken into consideration at an early stage of the expected ESAF-supported program.

As far as wheat subsidies are concerned, the Yemeni authorities are more cautious in removing them, for obvious reasons. However, I would want to raise some points in this respect: the domestic price represented in 1996 only 23 percent of the $import cost; domestic consumers were shielded from the external price developments, and the low domestic price stimulated increased demand, the more so after the elimination of the rice subsidy. It is no wonder in these circumstances that the subsidy tripled from 1995 to 1996, and reached as much as 8.1 percent of GDP. The high budgetary cost was exacerbated by the import of flour; the limited milling capacity—claimed by the authorities—appears to me not as important as the incentive to increase the import, irrespective of price, due to the subsidy mechanism. Even the social protection purpose of the subsidy appears questionable: a more targeted mechanism could indeed support the disadvantaged social groups, at a much lower overall cost for the budget. For all these reasons, I think that postponing the removal of subsidies until 2001 means in fact accepting to waste resources for too long; not to mention that 2001 should be rather close to the next elections. Therefore, I would suggest that, sometime during the expected ESAF arrangement, these subsidies be gradually removed, as well—and be replaced with other better targeted social protection means.

The progress in civil service retrenchments in 1996 was disappointing: it reached 36 percent of the target in the case of persons beyond retirement age and only 16 percent among "at home" workers—who in fact are unemployed, and continue to receive wages. There is not much to be said about this situation. I fully agree with Ms. Lissakers' statement that retrenchments planned for 1996 should be prior actions for an ESAF-supported program.

With these short comments, our chair can approve the completion of the review, the nonobservance of some performance criteria notwithstanding, and wish the authorities every success in their endeavor.

Mr. Shaalan considered that the question raised by Mr. Mirakhor concerning whether the exhaustive list of structural measures envisaged under the program might tax the authorities' administrative capacity was extremely important not only for the Republic of Yemen, but also for a number of developing countries.

As the Executive Directors who had participated in the recent group travel to The Republic of Yemen were aware, the transformation of the economy that had taken place since 1994 was extremely impressive, Mr. Shaalan commented. The people of the Republic of Yemen were clearly committed to reform. However, the social indicators in the Republic of Yemen with respect to health and education were low; thus, the country's administrative capacity remained weak. In that respect, it would have been preferable for the program to have focused on making significant progress in a few key structural reform areas, rather than including such an exhaustive list of measures to be taken in a broad array of sectors within a short time. Although the authorities were clearly determined to implement appropriate reforms throughout the economy, the Republic of Yemen might not have the necessary administrative capacity to fully accomplish all of the goals that had been set for it. It was pleasing to note that, in its future discussions with the Yemeni authorities, the staff would carefully take into account the limitations facing the country.

The staff representative from the Middle Eastern Department said that the structural reforms envisaged under the program were ambitious. Nevertheless, the remarkable progress achieved thus far suggested that the Republic of Yemen's administrative capacity was greater than might be expected. In addition, the Republic of Yemen was receiving technical assistance from the Fund and other organizations, such as the UNDP, in the implementation of certain reforms. While the staff did not intend to overwhelm the authorities' administrative capacity, it considered that the Yemeni authorities were correct to set ambitious goals.

Mr. Mirakhor commented that it was pleasing to note the important strides that had been made in the area of structural reform. It was also comforting to note that the staff was mindful of The Republic of Yemen's administrative capacity. It was precisely because of the impressive progress achieved in the initial phases of reform that care should be taken not to overstretch the remaining capacity at the margin. It might be possible to achieve greater success at the present stage by lowering expectations somewhat and by a more focused effort in a few key areas.

The staff representative from the Middle Eastern Department noted that the Yemeni authorities had agreed that any net proceeds from the privatization effort would be used to reduce government debt to the central bank. However, if any proceeds were realized, they would likely be very modest once the debts of the public enterprises were settled and the costs of the separation, or "buyout," packages were met. Indeed, because of the buyout packages, the privatization effort might result in a net charge to the government. In that connection, the authorities had begun discussions with the Bank staff on an IDA credit to support an acceleration of the privation program, including through the financing of enhanced buyout packages.

It should be noted, with respect to the civil service retrenchment effort in 1996, that the buyout packages offered by the government had not been sufficient to induce civil servants or public enterprise employees to essentially sell their tenure rights, the staff representative said. While the civil servants and public enterprise employees who were eligible for retirement were covered by the pension fund, a large number of the workers to be retrenched were not yet eligible for retirement and were not willing to sell their tenure rights.

With respect to the higher than originally envisaged subsidy bill that had resulted in a breach of the end-1996 ceiling on primary nondevelopment expenditure, it should be noted that the Yemeni authorities remained committed to the elimination of energy subsidies by 1999 and to the elimination of wheat subsidies by 2001, the staff representative stated. Consistent with that commitment, significant price increases were expected to take place over the coming year. Price developments in 1997 would have a substantial impact on the ratios of domestic prices to world market prices. Therefore, the price ratios set forth in EBS/97/54 would likely become outdated within a few months.

As to the arrears to non–Paris Club creditors—in particular the Russian Federation, which was the Republic of Yemen's largest creditor—the Secretary of the Paris Club and the authorities of the Russian Federation were currently engaged in discussions on the technical issues related to Russia's participation in the Paris Club, the staff representative noted. The Secretariat, on behalf of the Paris Club, had asked the Russian authorities not to conclude bilateral debt relief agreements with developing countries until those discussions were concluded.

The staff was pleased to note the progress that had been made by The Republic of Yemen in addressing the problem of energy sector public enterprise cross arrears, the staff representative continued. In a very short period, The Republic of Yemen had managed to virtually resolve the problem of those interenterprise arrears, an issue that many economies in transition had been grappling with for years. Indeed, the impressive progress achieved in that area gave reason for confidence in The Republic of Yemen's administrative capacity.

The staff did not consider that it would be useful to impose penalties for interenterprise arrears in the case of The Republic of Yemen, the staff representative went on. As most of the enterprises involved were state-owned, the penalties would ultimately impact the budget in a circular manner.

With respect to the civil service retrenchments for 1996, it should be noted that civil servants and public enterprise employees had "tenure rights," under the current laws, the staff representative added. Therefore, some time would be needed to put in place the legal framework needed for an acceleration of the retrenchment program. In the light of the authorities' demonstrated commitment to reform and the comprehensive program currently under consideration that could be supported under the ESAF, the staff would not recommend making civil retrenchments a prior action for an ESAF arrangement. To do so might cause delay in the movement toward an ESAF arrangement, which would include a comprehensive reform of the civil service.

A more transparent privatization law had been drafted with assistance from the World Bank and had been approved by the cabinet in November 1996, the staff representative noted. The parliament was expected to ratify that draft law by mid-1997.

It was important to distinguish between the questions on municipal clearances, which were related to investment proposals, and those on the public works program, which were related to the nature of the formulation of public works projects supported by the World Bank, the staff representative considered. With the elimination of the municipal clearance requirement, obtaining such clearances for investment undertakings—either licensed or unlicensed—was no longer necessary.

The Yemeni authorities were aware of the need to diversify exports, the staff representative noted. That was one of the primary objectives of the authorities' recent moves to reform the exchange system, eliminate import licenses and import bans, reform the tariff structure, and harmonize export taxes. It was to be hoped that those measures would lead to a greater diversification of exports over the coming years.

It was the staff's understanding that a firm comprised partly of Saudi Arabian private sector investors had put forward a proposal to fund the modernization of the Port of Aden in exchange for a long-term franchise, the staff representative from the Middle Eastern Department said. Under that proposal the Port of Aden would be taken over completely by the private sector. However, discussions on that proposal were still under way at the present stage.

Mr. Shaalan thanked Executive Directors for their comments for the current discussion and their interest in recent developments in The Republic of Yemen. The advice and encouragement offered by Directors for the current discussion would be conveyed to the Yemeni authorities as quickly as possible.

The Executive Board took the following decision:

1. The Republic of Yemen has consulted with the Fund, in accordance with paragraph 10 of the Stand-By Arrangement for the Republic of Yemen (EBS/96/38) and paragraph 43 of the letter dated March 5, 1996, as amended, from the Minister of Finance and the Governor of the Central Bank of The Republic of Yemen, in order to review progress made in the implementation of the policies and measures described in the Memorandum on Economic and Financial Policies of the government of the Republic of Yemen attached to that letter and in order to reach understandings regarding the circumstances in which purchases under the arrangement can be continued.

2. The letter from the Minister of Finance and the Governor of the Central Bank of Yemen dated March 18, 1997 shall be attached to the Stand-By Arrangement for the Republic of Yemen, and the letter of March 5, 1996 shall be read as supplemented and modified by the letter of March 18, 1997.

3. Accordingly, the limits referred to in paragraph 3(a)(i), (ii), (iii), (iv), and (vi) of the Stand-By Arrangement on: net domestic assets of the banking system, claims on the public sector by the banking system, net claims on the central government by the banking system, authorizations of primary nondevelopment expenditure of the central government, and the contracting of nonconcessional external debt; the floors referred to in paragraph 3(a)(v) of the Stand-By Arrangement for net international own reserves of the Central Bank

of Yemen; and the intentions regarding arrears on external debt service payments referred to in paragraph 3(b) of the Stand-By Arrangement shall be as specified and described in paragraph 12 and Annex I; paragraph 16 and Annexes II and III; and paragraph 17, respectively, of the letter of March 18, 1997 attached to EBS/97/54.

4. The Fund decides that the second review contemplated in paragraph 3(c) of the Stand-By Arrangement as amended is completed and that, notwithstanding the performance criteria specified in paragraphs 3(a)(i), (ii), (iii), (iv), (v), (vi), and 3(b) of the Stand-By Arrangement, the Republic of Yemen may continue to make purchases under the arrangement. (EBS/97/54, 3/31/97)

Decision No. 11485-(97/42), adopted
April 21, 1997

After adjourning at 1:10 p.m., the meeting reconvened at 2:35 p.m.

3. MALI—ENHANCED STRUCTURAL ADJUSTMENT FACILITY—SECOND ANNUAL ARRANGEMENT

The Executive Directors considered a staff paper on Mali's request for a second annual arrangement under the Enhanced Structural Adjustment Facility (EBS/97/65, 4/8/97). They also had before them a policy framework paper for Mali for the period 1997–99 (EBD/97/38, 4/8/97).

The staff representative from the African Department said that additional information on program implementation for the first quarter of 1996 had been received after the staff paper for the current discussion was circulated.

As of March 31, 1997, cumulative government revenue had exceeded indicative targets in the program by 13 percent, owing to improved collection from all revenue-collecting agencies, the staff representative stated.

With respect to the wage bill, the amount paid at the end of March 1997 was 8 percent below the target for end-March, mainly because the government had decided to give the increase of 5 percent described in the staff paper as of May 1, 1997, the staff representative noted.

With respect to external debt negotiations, the Paris Club Secretariat had extended to May 30, 1997 the date for concluding the last bilateral agreement with creditors, the staff representative continued. A delegation from the Russian Federation was expected to visit Bamako in May 1997 to discuss renegotiation arrangements.

Finally, on April 16, 1997, the export tax on raw skins of sheep and goats had been rescinded by the government, the staff representative from the African Department said.

Mr. Barro Chambrier, speaking on behalf of Mr. Yao, made the following statement:

Mali has achieved considerable economic progress, in recent years, through the successful implementation of a wide range of strong financial and structural policy measures that were included in Fund-supported programs. Particularly noteworthy, is the observance of all performance criteria and structural benchmarks set under the first annual ESAF-supported program in 1996.

For the medium-term, my Malian authorities are determined to pursue their adjustment efforts unabated. In that context, they are in broad agreement with the staff analysis of Mali's prospects and related policy recommendations. The main objective of my authorities' strategy is to further strengthen the foundation of the Malian economy through the implementation of strong adjustment programs.

During the period 1997–99, Mali's strategy aims at creating a favorable environment for a strong and sustainable economic growth, thereby alleviating poverty through the development of social sectors. To that end, my Malian authorities recognize the need to continue the implementation of a tight fiscal policy, supported by an appropriate monetary policy at the regional level. They also see the importance of pursuing their structural adjustment efforts in order to create an enabling environment for the private sector, and promote as well as diversify the production of export commodities.

This strategy enjoys a broad-based political support as it was designed in close collaboration with the civil society. There is, therefore, a large consensus on the need to streamline the public sector and devolve some decision-making powers to local authorities, in order to facilitate the collection of taxes on agricultural output and informal economic activities.

The 1997 program is broadly consistent with the government's medium-term strategy. In the fiscal area, the authorities' efforts remain strong and aim at increasing public savings as well as reducing the need for external budgetary assistance. Indeed, despite the impact of the general elections and the National Pact on the budget, the overall fiscal deficit will remain below its original target of 9.1 percent of GDP. Its financing will be covered only by external and nonbank resources. This outturn will be the result of actions on both the revenue and the expenditure sides of budgetary operations.

On the revenue side, the authorities have initiated efforts to broaden the tax base and minimize tax evasion. They are also implementing the action plan for the customs administration, which requires the streamlining of custom clearance procedures and the reorganization of inspection units. In addition, the exemptions unit will be enhanced.

Total government expenditure is projected to increase. This increase reflects the cost of the elections, additional expenditure in social sectors, and an adjustment in the wages of civil servants to contain further erosion in real wages, which have continued to decline since 1994.

My authorities would like to stress that adequate resources are allocated to education and health sectors. Their shares in current expenditures are projected to increase from 22.5 percent and 8.3 percent in 1996 to 23.4 percent and 9.6 percent in 1997, respectively. In addition, budgetary resources will be available to assist the disadvantaged population groups: nationwide vaccination program, provision of water in rural areas, and the establishment of revolving funds for income-generating projects for women.

Monetary policy is characterized by prudent credit expansion. The increase in money supply is projected to be in line with nominal GDP growth. To improve the efficiency of monetary policy, efforts are being pursued to make an increase use of indirect instruments. In that context, interest rates will continue to be market-determined. In addition, the establishment of a regional financial market and the deepening of open market operations are expected to accelerate the process of diversifying financial instruments.

In order to achieve an efficient allocation of bank credit, efforts to strengthen the banking system are being intensified. In that framework, the monetary authorities will help the banks in their efforts to recover nonperforming loans and increase provisioning, as well as ensure that banks adhere to the prudential ratios set by the regional banking commission.

In the area of structural reforms, the government has decided to concentrate its actions on three key areas: (1) private sector development through an improvement of the regulatory framework; (2) the reform, of state-owned enterprises; and (3) agricultural sector reforms. To develop the private sector, my authorities have taken a number of actions on the legal front namely the creation of an agency for the inspection of judicial services, revision of business law in the context of the ongoing regional harmonization of policies in this area. In addition, efforts are being pursued to improve the banking soundness.

As regards the reform of state-owned enterprises, the action plan adopted in 1996 will be implemented as envisaged. The privatization and restructuring of public enterprises will be stepped up. During the course of this year, some public enterprises will be offered for sale; the government's minority shares in five enterprises will also be sold. Enterprises remaining in the government's portfolio will be restructured and the authorities will continue to monitor closely their management and financial situation.

To promote agricultural development, the authorities will pursue relentlessly the restructuring of the cotton sector in the context of the CMDT performance contract for the 1993/94–1997/98 and its ongoing investment program. In the rice sector, tariffs on imported rice will be reduced to ensure full competition in the marketing and distribution of rice.

In the external sector, my Malian authorities will like to continue to promote an export-oriented strategy. A strong growth of exports is expected from increased investment activity in cotton, livestock and gold exploitation sectors. Nontraditional exports, such as fruits, vegetables and textiles are expected to pick up strongly during the years ahead. Import growth is projected to remain moderate. This will mainly reflect the increased competitiveness of domestic production.

In conclusion, I would like to reiterate my authorities' commitment to the adjustment effort. Also, they are of the view that the success of their strategy hinges on timely availability of external grants and highly concessional loans, because the country continues to be beset by high debt burden, even through Mali has been granted the stock of debt reduction on Naples terms by the Paris Club in May 1996.

Mr. Fontaine, speaking on behalf of Mr. Autheman, made the following statement:

Mali's policy performance has been outstanding: the ESAF program has remained fully on track, with all performance criteria and benchmarks through December 1996 observed; Mali has succeeded in attracting foreign direct investments and reorienting public expenditures into areas that are crucial to long-term development, including social sectors; important sectoral reforms have been made to improve infrastructure services and expand agricultural production. The performance of the cotton agency is particularly noteworthy and staff rightly pointed out the link between agricultural performance and poverty reduction.

The key challenge is to sustain, and preferably to increase economic growth. A growth rate of 5 percent on average, as projected by staff, still remains below what is desirable.

I agree with staff's main recommendations in their appraisal:

the importance of pursuing prudent macroeconomic policies—and especially of avoiding any fiscal slippages during this election year—to boost confidence;

the need for translating the authorities' genuine commitment to private sector development into specific measures to improve the regulatory and judicial framework in which the private sector is operating.

While I am convinced that this approach is the right one, I also welcome the World Bank's proposed study on the "accelerated growth strategy." Some Fund staff's involvement in that study would be useful, as it could help us in identifying what the role of the Fund should be in "second generation" ESAF programs.

On the second annual arrangement under the ESAF, I have two questions:

the privatization program encountered delays in 1996, which do not seem attributable to authorities' actions (staff reports "unsatisfactory bids" in one case, "disagreement on management issues with the prospective buyer" in another case). What are these "bolder steps" advocated by staff which could be taken to accelerate the privatization program?

a regionwide tariff reform is under preparation. Staff recommend a low common tariff and a low preference margin. I concur with that objective. Are there differences of views on this recommendation among governments concerned?

Extending his remarks, Mr. Fontaine noted that the staff appraisal had put forward certain recommendations concerning Malian trade policy. As it was not clear whether there was a Malian policy on trade or a regional policy, it would have been more appropriate for the staff to address trade issues on a regional level, in particular to ensure consistency among countries involved in the regional trade reform effort.

Since broad agreement had been reached on the direction of the reform and its objectives, the principal matters for concern involved primarily questions of emphasis and sequencing, Mr. Fontaine considered. The staff's recommendations clearly emphasized a reduction in external tariffs. Given the relatively small size of the West African economies, trade and private investment would be bolstered by low internal tariffs. However, there was an important need to consider the lowering of external and internal tariffs with a view to their budgetary implications, which represented binding constraints for some countries in the region, in particular the enclaved countries. It would also be important to ensure that the reduction in internal tariffs was carefully sequenced in a way that would not preclude reductions in the external tariff if revenue losses remained manageable.

In the light of those considerations, a progressive and regional approach was clearly needed with respect to the countries of West Africa, Mr. Fontaine commented. The staff should be careful in pressing the Malian authorities in any specific direction.

Mr. Daïri made the following statement:

After substantial progress in stabilization and structural adjustment under the first program with the Fund, Mali resolutely launched its second program, which is very successful so far. All quantitative performance criteria and benchmarks under the first annual program were observed, as indicated by Mr. Yao in his helpful statement. The overall fiscal deficit declined from 10.5 percent of GDP to less than 8 percent, which is better than programed. While real GDP grew by 4 percent as targeted, the inflation rate halved to 6.5 percent, which is below the revised target of 7 percent. Broad money increase slowed down to 8 percent, with a significant improvement in government's creditor position, leaving room to a substantial increase of credit to the private sector. The external current account position improved as a result of continued strong export performance and moderation of imports after the 1994 devaluation, which resulted, together with the stock of debt reduction and larger external budgetary assistance, in a strengthened net foreign assets position.

Although revenue performance was substantially higher than under the program, the authorities continued expenditures restraint, especially in the wage area. However, in the context of prudent expenditure policy, they attempted to allocate adequate amount of outlays on social services, including health education and the social safety net, as well as on public investment. We welcome the reduction in domestic payments arrears, which exceeded program targets.

Progress on structural reform was also significant. This included the adoption of a timetable for privatization and rehabilitation of public enterprises, as well as effective sale or launching of bids for a number of enterprises. The authorities also took measures to improve the legal and administrative business environment.

We welcome the objectives and strategy set for 1997–99. The projected increase in private and government savings, together with higher and more efficient investment, is expected to lead to stronger growth and a reduction in the current account deficit, whereas inflation is projected to decline further to very low levels. Fiscal consolidation will continue to play a critical role in the adjustment policy, whereas a wide range of structural reforms is geared toward strengthening private sector role, economic diversification, and social development.

It is encouraging to note that fiscal consolidation is projected to continue under the second annual ESAF, despite the nonrecurrence of the exceptional revenue of 1996 and the elections-related expenditure in 1997. I have a few comments regarding some of the exceptional revenue collected in 1995 and 1996. First, regarding the accumulation of value-added tax credits, I wonder if it was not possible for the staff to discuss with the authorities the possibility of excluding such revenue to achieve greater transparency of the fiscal account. I also wonder whether provision has been made to reimburse tax credits accumulated in 1996–99. Second, it seems that the recovery by the government of on-lent debt of CMDT should have been included in expenditure and net lending and not among revenue.

The authorities' efforts at strengthening customs and tax administration and broadening tax base are steps in the right direction. I would like the staff to comment on how the extension of the drawback system can contribute to the broadening of the tax system. It seems to me that this measure aims more specifically at reducing the distortions affecting the export sector and should rather be considered as a means of export promotion. While the post-conflict situation in the north requires some flexibility in hiring former combatants, the authorities are well advised to limit the increase in the wage bill. We encourage the authorities to continue giving highest priority to expenditure on education and health in view of the poor—albeit improving social indicators. We welcome the authorities' intention to resist wage claims beyond the budgeted 5 percent increase and to offset any expenditure overruns for the elections by saving under other expenditure categories, and we hope that social sectors would be adequately protected.

While we support further fiscal consolidation, we need to put Mali's fiscal performance in perspective. At Mali's level of GDP per capita and social indicators, we can only welcome the donor community's support to strengthen the low level of domestic savings. It is already a good performance for the government to finance almost a half of its capital expenditure through public savings and that it does not have recourse to domestic banks or nonconcessional external borrowing. Furthermore, the improvement in capital output ratio called for by Mr. Heinbuecher can only be achieved through further improvement in human resource development, which in turn maintains high pressure on the budget.

Despite the recent decline in the ratio of nonperforming loans, their level remains high. The authorities are well advised to strengthen their efforts at improving banks' loan recovery. Their efforts at strengthening the banking system are welcome, including the rehabilitation of the Banque Internationale du Mali and the privatization of the "Banque malienne de credit et de depot."

The structural reform program is well designed and specified. It aims at further modernization of the business environment. Together with the continued improvement in macroeconomic policies, its implementation will set the stage for stronger and sustainable growth. I support Mr. Fontaine's comment on Mali's trade policy, including his suggestion that it should be discussed at a regional level.

The authorities' track record of policy implementation is strong, and their commitment to further adjustment and reform is well established. We take note of the staff's intention to prepare a debt sustainability analysis, and we call for an appropriate assessment of the vulnerability of Mali's exports and fiscal position to weather and other exogenous shocks. We consider that Mali's low GDP per capita and social indicators should be taken into account for consideration of its eligibility to HIPC Initiative.

We support the proposed decision and wish the Malian authorities every success in their courageous endeavors.

Mr. Loevinger made the following statement:

Like other speakers, we want to commend both the authorities and the staff for their impressive achievements. Mali serves as an important reminder of what can be achieved when the Fund insists on rigorous policies and the authorities act with determination. However, it is important to remain humble. Some of Mali's success has been due to favorable price trends in key commodities. And despite its impressive track record after almost nine years of Fund arrangements, per capita GDP remains low and Mali remains highly dependent on the export of a single commodity.

In the short term, as the elections approach, we agree with Mr. Autheman that it is important for the authorities to resist pressure to loosen financial policies and delay key structural reforms. In the medium term, more needs to be done to reduce macroeconomic imbalances and reduce structural barriers in order to achieve the high rates of growth, that are so desperately needed. Despite all that has been achieved last year, there are signs in the proposed arrangement for 1997 that the pace of reform is starting to slow.

First, the programmed fiscal consolidation for this year is much less ambitious than last year's. While Mr. Barro Chabrier noted that his authorities aim to increase public savings, public savings in fact are programmed to decline this year. The authorities are counting on this to be offset by a large increase in private savings, but predicting private savings behavior is very difficult.

The overall fiscal deficit, excluding grants, would increase by almost one percentage point of GDP this year. As other speakers have pointed out, some of this is due to exceptional revenues last year, resulting in part from the accumulation of credits on the value-added tax. This raises a general issue of what Fund policy should be when a country overperforms. Should it build on good performance or simply maintain the original targets? However, even taking into account a comparison of the programmed deficits for 1996 and 199, there would be a decline of only 0.3 percentage points of GDP.

In the case of Mali, it seems that some of the dividends from the overperformance are going into the wage bill. As other speakers have noted, the proposed 11 percent increase in the wage bill seems excessive. We wonder whether it would have been more efficient to focus on providing former combatants with the skills to succeed in the private sector, rather than further boosting the payrolls of the security forces and civil service. It would be interesting to hear either the staff's or the World Bank representative's views on this.

Further efforts are needed to improve the composition of government revenues and expenditures. It is disappointing to note that military spending will continue to increase in real terms under the program. Furthermore, it is disappointing to note that, after almost nine years of Fund-supported programs, Mali still remains a highly protected economy. Trade taxes, either as a percentage of GDP or of imports, are programmed to increase under the program. We agree with Mr. Fontaine that there is a need for both low external and internal tariffs, and we also agree that the staff should not be sanguine about this. We would have liked to have seen more specific commitments to reduce Mali's dependence on trade taxes in the arrangement, rather than general comments that this will be done on a regional basis.

While a lot of preparatory work has been done and the structural benchmarks under Fund-supported programs have been met, the government has not yet turned over to the private sector a significant share of the government's stake in public enterprises. Programmed privatizations for this year would only slightly reduce the government's holdings in state enterprises. Like Mr. Autheman, we would be interested in knowing what bolder steps could be taken to get the privatization process moving.

Mr. Santos made the following statement:

We commend the Malian authorities for their good performance under the ESAF-supported program. However, the economic situation in Mali is still fragile. Domestic and external imbalances are still high and not significantly different from what they were just before the devaluation of the CFA franc in 1994. Inflation, measured on the basis of the consumer price index, has yet to reach the level prevailing prior to the devaluation, contrary to the experience of other CFA franc countries. Reducing inflation to the level of partner countries is not only a program goal, but also essential to prevent further losses of the competitiveness that the economy gained with the devaluation of the CFA franc. In this respect, we wonder why the end-of-period consumer price index is projected to increase in 1997 to 6 percent from an estimated 2.8 percent in 1996.

On the fiscal side, we welcome the very good performance both on the revenue and expenditure side, with program targets being met by comfortable margins. However, tax revenues are still low as a percentage of GDP, and further efforts need to be made to broaden the revenue base and to rationalize exemptions from import duties. In this regard, we would expect a stronger effort in 1997 toward fiscal consolidation. Indeed, although we are aware of the special factors that positively affected the fiscal performance in 1996, we are disappointed to note that the fiscal deficit is projected to deteriorate by almost 1 percentage point of GDP in 1997.

We would have preferred a program that was aimed at more ambitious goals than just reducing the overall fiscal deficit to less than 7 percent of GDP in 1999, and raising the total government revenue/GDP ratio to 15.5 percent by 1999.

On the monetary sector, we note that the lending interest rate, although declining, is still very high in real terms. We wonder whether this reflects increased provisioning for the significant level of nonperforming loans in bank portfolios. If the interest rate reflects a high risk premium on new loans, we would question the wisdom behind the significant increase in bank credit to the economy.

In any case, the still high interest rate spread must reflect less than effective financial intermediation. Hence, we urge the authorities to give renewed attention to the recovery of bad loans. Increased emphasis on provisioning would contribute to a tightening of lending terms, or even restrictions on lending, which, in turn, would reduce the banks' support for economic activity.

Progress achieved in structural adjustment reforms is broadly satisfactory. However, deregulation, opening up, and modernization of the economy should contribute to increased efficiency. We note that the productivity of capital is still quite low, as the high investment ratios—around 26 percent of GDP between 1994 and 1996—contrast with annual growth rates of about 4 percent of GDP for the same period.

The delays in public enterprise reform are regrettable. We urge the authorities to press ahead with the reform program in order to privatize or liquidate enterprises in those areas where the government has no compelling reason to be involved, and to strengthen the enterprises remaining in the public sector.

Mr. Jones made the following statement:

It is clear from the staff report that Mali's economic performance has been satisfactory. The authorities have indicated their commitment to continue with the reform process aimed at strengthening the foundation of the economy. I believe that the program that is in Mali offers good prospects. In this regard, I note the emphasis on human resource development and the alleviation of poverty; the efforts aimed at raising domestic savings and maintaining a high level of investment; and the continuation of reforms in the agricultural sector, aimed at increasing and diversifying production.

I am in broad agreement with the staff appraisal. Continued fiscal consolidation is critical to maintaining a stable macroeconomic environment, something which is needed to build confidence and encourage private sector investment. Efforts aimed at strengthening the banking system are also important.

Despite the progress made in recent years, the staff is right in calling attention to the still fragile economic situation, notably the high vulnerability to adverse weather conditions and terms of trade shocks. Mail's debt burden is also high. As Mr. Yao has indicated, the country needs the timely support of the international community to help it succeed with its adjustment effort I have one question: Why is it that the adjustment effort does not seem to be having a major impact on private capital inflows?

Mr. Tahara made the following statement:

Like other speakers, I welcome the authorities' achievements, including the resumption of economic growth and the reduction of the inflation rate and the fiscal deficit under the ESAF-supported program. Nevertheless, the economic structure still remains fragile and heavily dependent on the cotton industry. The authorities need to seek further structural reform in order to attain economic diversification. Strengthening of the fiscal base, including enhancement of revenue collection capacity, is another area where the authorities need to intensify their efforts.

As I broadly agree with the staff's analysis and policy recommendations, I will just briefly touch upon a few points for emphasis.

First, regarding export projections for 1997, it is encouraging that export volume is expected to increase by 19 percent. However, this increase is assumed to come only from traditional sectors—namely, from gold mining and cotton. Clearly more needs to be done to diversify the export base. Efforts to create a private-sector-friendly environment, including modernization of the regulatory and judicial frameworks, need to be strengthened.

Second, on the fiscal front, it is welcome that the fiscal deficit in 1996 has decreased thanks to expenditure restraint and revenue increase. Nevertheless, I would like to stress that a large part of the revenue increase came from exceptional receipts. Moreover, the current revenue-GDP ratio seems very low and there is much room for further effort on the part of the authorities. I therefore urge them to strengthen the revenue structure, particularly in the domestic revenue area, by expanding the tax base and strengthening revenue collection capacity.

Third, the delay in structural reform, including privatization of major public enterprises, is regrettable. I therefore urge the authorities to step up their efforts to implement their privatization program.

With these remarks, I support the proposed decision and wish the authorities well in their future endeavors.

Mr. Borpujari made the following statement:

The Malian authorities are to be commended for their steadfast adherence to the program. All performance criteria and benchmarks have been met. Indeed, performance has exceeded expectations in several areas. Nevertheless, additional efforts are still needed to put the Malian economy on a sustained growth path. Therefore, and given Mali's track record, I support the request for a second-year ESAF arrangement.

As to the details of the program, I am in broad agreement with the thrust of the agreed objectives and policies and have little to add to the staff appraisal. The success achieved so far should strengthen the momentum for reform and facilitate full implementation of the program.

With these remarks, I wish the authorities further success.

Mr. Alemán made the following statement:

Like other speakers, I would like to commend the Malian authorities for their achievements under the first annual ESAF arrangement during 1996. Their adjustment program has been successful and has remained on track. As the staff paper indicated, all performance criteria for end-June and the quantitative and structural benchmarks through end-December were observed. In addition, the Malian authorities' commitment to their objectives for 1997–99 under the ESAF arrangement is commendable.

In 1996 significant economic improvements were achieved, including GDP growth of 4 percent and a rate of inflation of 6.5 percent, almost half the level prevailing in 1995 and lower than programmed. In general, all of the macroeconomic objectives were achieved. Nevertheless, in spite of the encouraging results attained since 1992, Mali's economy remains fragile and vulnerable to external shocks. In addition, Mali has a low per capita income, and poverty is widespread. In this context, I concur with Mr. Autheman that Mali needs to achieve an economic growth rate higher than the 5 percent projected by the staff. I wonder whether the staff could comment on the prospects for attaining this goal.

The second annual ESAF arrangement, if it is successfully completed, would help the Malian authorities continue the implementation of prudent policies and economic measures to bolster economic growth in the medium term. As I am in broad agreement with the staff recommendations, I can limit my comments to a few points.

With respect to fiscal policy, we concur with the staff on the need to strengthen revenue performance while, at the same time, keeping a prudent expenditure policy. In addition, in order to maintain the momentum of revenue growth, tax and customs administration should be strengthened through measures aimed at maintaining an efficient and strong collection agency, widening of the tax base, and reducing tax fraud.

On the expenditure side, more prudent management is needed to keep the deficit on target. Therefore, strict control of budget expenditures should be enforced by the fiscal authorities, especially in view of the coming elections. Fiscal policy should be aimed at not only establishing better accounting procedures and expenditure control, but also adopting without hesitation contingency measures to offset any budget overruns. However, this containment of nonpriority expenditures should not hinder an expansion of social services and public investment outlays.

As to monetary policy, it will be important to develop prudent credit policies as a prerequisite for wider use of indirect instruments on a regional level and for the creation of a regional financial market.

The structural reform measures that have been taken and those envisaged under the second annual ESAF arrangement are commendable. However, further actions to promote private sector participation and economic growth, through the modernization of the regulatory and judicial frameworks, will be essential. We encourage the Malian authorities to press strongly ahead with the reform of public enterprises, not only through strengthening their management, but also through privatization as envisaged.

Finally, it should be emphasized that further successful economic progress in Mali will be dependent on the continued support of the international community. We support the proposed decision and commend the authorities for their efforts.

Mr. Heinbuecher made the following statement:

We only have two more general remarks.

First, I join other speakers in commending the Malian authorities for a broadly successful implementation of the first year under the present ESAF arrangement. We agree with the thrust of the staff appraisal and can support the proposed decision.

However, we do so with some unease since it seems not fully clear whether this Fund program really will make a difference. Mali—like some other member countries—has implemented already quite a number of Fund supported adjustment programs over an extended period of time, but is still confronted with significant macroeconomic imbalances, a fragile overall economic situation and—in staff's words—"will continue to rely heavily on concessional external assistance." Like Mr. Loevinger, we wonder, therefore, whether a much more ambitious adjustment path than in the past, especially to narrow the still sizable fiscal imbalances and to increase the degree of diversification of the economy and the export structure, would be warranted to achieve a significant strengthening of the economic situation and to reduce Mali's strong dependence on external support in the medium rather than the long term. It seems also worth remembering, for instance, that issues like strengthening the tax administration and limiting tax evasion have already been on the task list of the SAF-arrangement almost ten years ago. The information provided by staff today on the better revenue performance in the first quarter of this year is welcome as good news in this respect.

Secondly, we were encouraged that staff apparently has responded to our request to have a more complete picture of previous Fund-supported programs—not only in the case of Mali—included in the page on "Relations with the Fund" of Fund documents. In contrast to the earlier practices, which only provided information on the most recent three financial arrangement, the present document on Mali goes one step further and gives information on four arrangements. We welcome this as a first step in the right direction and look forward to finally reach the stage of full disclosure of all previous arrangements in the near future.

Ms. Zheng made the following statement:

Like previous speakers I am satisfied with Mali's program implementation. I support the authorities' request for the second annual arrangement under the ESAF and the proposed decision. I wish the authorities further success.

Ms. Kouprianova made the following statement:

The impressive performance of the Malian economy since our last discussion is very encouraging. The authorities have undertaken strong policy efforts, and these efforts have resulted in the achievement of all the performance criteria for end-June and in the achievement of all the quantitative and structural benchmarks through end-December. We consider this second-year program to be sufficiently ambitious, and urge the authorities to implement all envisaged policy measures without significant deviation in order to maintain their good track record in achieving the country's performance objectives.

As we agree with the staff assessment and support the recommendations contained in the staff paper, I can limit my comments for the current discussion.

We are encouraged by the progress made by the Malian authorities in resolving outstanding issues of external indebtedness. The stock of debt operation with the Paris Club creditors in May 1996 will certainly benefit a country that could be considered among the most heavily indebted in the region. My authorities welcome the intention of the Malian government to resolve the issue of Mali's outstanding debt to the Russian Federation, and to conclude a final agreement on debt relief in the near future.

We wish the Malian authorities all the best in continuing their adjustment efforts.

The staff representative from the African Department said that the staff was currently taking a two-pronged approach with respect to trade issues. Matters related to internal and external tariffs were being discussed simultaneously with the West African Economic and Monetary Union (WAEMU) and with individual countries. The staff was taking a similar approach with respect to monetary policies. Consultations with the Central Bank of West African States (BCEAO) on systemic issues were being held twice a year, in addition to the staff's regular consultations with individual countries.

During the initial stages following the introduction of the value-added tax, the authorities had encountered implementation difficulties, the staff representative recalled. As a result of those difficulties, tax credits had unwittingly been allowed to accumulate, particularly with respect to the export sector and, more specifically, the cotton marketing agency, CMDT. Once the government was able to ascertain the total amount of the credits, it planned to wipe out those arrears at a rate of about CFAF 3 billion per year during 1997–99, as provided for under the budget.

The drawback system had been introduced to ensure that all imports were processed as if they were taxed, the staff representative from the African Department stated. The government then provided reimbursements to those who qualified for exemptions. Because the system significantly reduced the occurrence of fraud, it represented a way to enhance revenue collection without changing tax rates.

Mr. Daïri noted that the drawback system was not limited only to imports, but also applied to other areas of the economy. He wondered whether it was expected to lead to a lower level of tariffs. In that case, it might be better to reduce tariffs in a more transparent fashion from the outset.

The staff representative from the African Department said that, at the present stage, the authorities were experimenting with the drawback system as it applied to the taxes and duties paid on petroleum products by beneficiaries of exemptions to other duty-exempt imports. If the system proved to be successful, they would extend it to other products that were exempt from taxes and duties, and for which there was a large potential for fraud. The question of whether it might be more effective simply to reduce the level of tariffs would likely be taken up by the West African Monetary Union in the context of its discussions on a common regional tariff system.

The staff would agree with Mr. Daïri that on-lending should be treated as part of net lending, the staff representative stated. The problems related to on-lending were shared by all countries in the region, although each country seemed to have a different way of dealing with it. The staff was currently working with the WAEMU Commission in an effort to develop a harmonized presentation of fiscal accounts that would handle on-lending in an appropriate manner.

The staff's medium-term projections on capital flows to the private sector were conservative, the staff representative continued. In that connection, it was important to bear in mind that the large flows of investment connected with the development of the gold sector in 1995/96 were drawing to a close, and it was not clear at the present stage whether similar levels of capital flows could be expected in the future. Therefore, the staff had preferred to err on the side of caution. Nevertheless, the staff would reassess the prospects for future capital flows at the time of the midterm review under the program and revise its projections accordingly.

While domestic savings were projected to rise from about 12 percent of GDP in 1996 to about 17 percent in 1999, that increase was expected to emanate primarily from increased corporate savings following the coming on stream of the Sadiola gold mine—which was projected to produce up to 10 tons of gold in 1997—and the improved export performance and profitability of the cotton sector, the staff representative went on.

Progress under the privatization program had been slow thus far, the staff representative from the African Department commented. While the government had turned over about 6 percent of its holdings to the private sector over previous years, and it was expected to turn over another 7 percent of its holdings to private sector activity in 1998, the total turnover, at only 13–15 percent over a period of five to six years, was disappointing.

Mr. Loevinger remarked, with respect to the privatization effort, that the African Department seemed to condone a more gradual approach in the countries it assisted than did other area departments, such as the European II Department.

The staff representative from the African Department responded that, although he was not in a position to compare developments in Mali with countries in other regions, the pace of Malian reform seemed to be consistent with its current implementation capacity. Nevertheless, it was to be hoped that the government could obtain additional technical expertise in preparing companies for privatization. That area seemed to pose the greatest difficulties. For example, the authorities had encountered two major difficulties in the privatization of the national tobacco company, SONATAM, in 1996. First, the government and the prospective buyer could not agree on the net worth of the company. As the buyer had financed the audit, it was not possible to determine whether or not it had been biased, but the government did not agree with the results of the audit. Given such situations, it clearly would be best for the government to contract its own experts to assess the net worth and financial positions of enterprises scheduled for privatization. Those audits could serve as a starting base for negotiations with prospective buyers. In that, and other respects, the staff was encouraging the authorities to push forward more aggressively in order to accelerate the privatization process.

Mr. Fontaine noted that the staff had indicated that the government had turned over about 13 percent of it holdings to the private sector thus far. He wondered whether the cotton sector and the main utilities, like the energy company, were included in the remaining share of government holdings. He also wondered whether the privatization of the national tobacco company, SONATAM, would represent a significant reduction in the overall share of the government in the productive sectors.

The staff representative from the African Department said that the turnover of 13–15 percent that had taken place thus far represented the government's holdings of capital in the public enterprise sector. The staff was not in a position at the present stage to estimate the size of the government's holdings, excluding the cotton marketing agency, CMDT, and the utilities, but it was not clear that such a figure would show that faster progress was being made in the area if privatization.

The staff projections on the rate of inflation for 1997, as measured by the consumer price index might be pessimistic, the staff representative stated. During 1996, a shortage of dry cereals, in particular rise, millet, and sorghum, had led to a sharp rise in the price of staple foodstuffs. As similar developments were likely to take place in 1997, the staff had based its projections for 1997 on that premise. However, the staff had recently been informed that the Malian authorities were taking measures to reduce the customs taxation on rice prior to the preharvest season in 1997 in order to contain the extent to which prices might rise. In the light of that recent development, the end-year inflation rate for 1997 might well turn out to be lower than currently projected.

Mr. Daïri considered that some of the comments put forward by Mr. Loevinger and Mr. Heinbuecher on the need for further fiscal consolidation highlighted the need to view Mali's recent performance from a global perspective. The level of GDP per capita and other social indicators in Mali clearly indicated the need for continued support from the donor community. Indeed, given the current circumstances of Mali, it would be difficult to expect an elimination of the need for budgetary support within a short period.

It was to the authorities' credit that almost half of government investment expenditure—which was critical for a country with so many infrastructural and development needs—was currently financed through public savings, Mr. Daïri said. Moreover, Mali did not rely on either domestic bank financing or foreign nonconcessional credit. Given the progress that had been made thus far in the fiscal area, it might be appropriate to expect the authorities to continue to press forward toward progressive improvements over time, but it would not be realistic to expect a rapid sea change in Mali's overall situation. For example, an improvement in the capital output ratio as called for by Mr. Heinbuecher could be brought about only through significant improvements in the development of human capital, which, in turn, would place a heavy and constant burden on the budget.

Taking into account the current circumstances of Mali, Mr. Loevinger and Mr. Heinbuecher were correct to encourage the authorities to continue to make improvements, Mr. Daïri considered. However, it would not be realistic to expect miraculous progress in a short period.

Mr. Loevinger responded that he could agree with Mr. Daïri that there was a limit to what could be achieved in Mali within a short period. Indeed, the progress achieved by Mali in 1996 represented about the best that could be expected in any African country. However, the targets under the proposed program for 1997 suggested that the pace of reform was likely to slow in the period ahead. That gave rise to important questions concerning whether countries should be allowed to revert back to original program targets following periods of overperformance, or whether they should be expected to build on their accomplishments.

The staff representative from the African Department noted that Mali was making significant progress in its efforts to diversify the tax base. However, much remained to be done before it would be possible to further reduce trade taxes. A study was currently under way on possible modalities for the introduction of a better focused form of direct taxation. Nevertheless, while better forms of direct taxation would help, what was really needed in Mali, as well as in other countries within the WAEMU, was a system that would enable the government to tax the agricultural sector without destroying incentives for production. The agricultural sector, which currently accounted for 30–40 percent of GDP, was not covered under the current tax system. The only way many countries had to capture farm revenues was through the taxation of exports. The authorities were aware of that problem, and they were examining ways to address it.

The staff representative from the Policy Development and Review Department recalled that a number of Directors had expressed concerns that Mali remained a highly protected economy. While the staff did not disagree with that assessment, and its recommendations were clearly aimed at furthering and accelerating the trade liberalization process in the context of regional initiatives, it was important to view the questions related to trade reform from a proper perspective. As the issues related to trade policy in Fund-supported programs, including those related to the pace of liberalization and the problems that frequently arise in liberalization would be taken up in detail in a staff paper to be brought to the Board in late July 1997, he would not dwell on those issues for the current discussion. However, it was important to bear in mind that protection was difficult to measure in quantitative terms. For example, while Mali had an average tariff of about 23 percent—compared with the average for all ESAF countries of about 19 percent—it had only three tariff bands, compared with an average of four tariff bands for the ESAF-eligible countries as a whole. Therefore, although Mali could be seen as an overly protected economy from the perspective of the average level of tariffs, it had less nontariff protection, and thus fewer distortions than many other countries. Nontariff protection was not only more insidious than more transparent forms of protection, it was also likely to be higher than tariff protection. From that perspective, the situation of Mali compared with those of other ESAF-eligible countries might be better than it appeared on the surface.

That was not to say that the staff was sanguine about the need for further trade liberalization in Mali, but only to illustrate that the issues involved were very complex, the staff representative commented. It was important to bear in mind the need to take into account the relationship between tariff revenues and other revenues—a point that would be covered in the forthcoming staff paper on trade liberalization in Fund-supported programs. It was also important to take into account the starting point from which countries began their reform efforts. In that respect, the situation of Mali and other African countries was very different from that of the transition economies in other regions. For example, when they began their reform efforts, most of the transition economies in Eastern and Central Europe had had wider domestic tax bases than many African countries had today. Thus, trade liberalization programs for African countries had to be designed in a way that would take into account an array of domestic and external issues.

Mr. Loevinger remarked that, while it was helpful to compare Mali with other ESAF-eligible countries, it might also be useful to draw comparisons between Mali and some of the more rapidly growing developing countries, such as those in Asia, in order to examine various forms and levels of protection.

The staff representative from the Policy Development and Review Department suggested that, in order not to extend the current discussion unnecessarily, it might be best to take up detailed comparisons between countries and regions in the context of the broader Board discussion on trade policy under Fund-supported programs later in July.

Like many other African countries, Mali had achieved a great deal of trade liberalization that was not immediately identifiable on the surface, because it had taken place through movements from nontariff barriers to more transparent forms of protection, the staff representative noted. In that respect, the sequencing of reforms was always geared toward encouraging country authorities to build upon their past achievements. In other areas, such as fiscal policy, it was not always possible to make continuous progress at a steady pace, owing to a variety of both internal and external factors, including, in some instances, the emergence of unforeseen developments. The staff would take up the issues related to the pace and sequencing of various types of reforms in the forthcoming review of the ESAF.

Mr. Barro Chambrier thanked Directors for the support they had expressed for Mali's ongoing adjustment efforts and for the proposed program. He would convey the comments and recommendations put forward by Directors for the current discussion to his Malian authorities.

On behalf of his Malian authorities, he wished to reassure Directors that Mali remained committed to the pursuit of budget discipline and the reform process, Mr. Barro Chambrier said. As to the result of the recent elections, the Constitutional Court was expected to decide in the coming week whether another round of elections was needed. The court was meeting in the spirit of maintaining peace in the country. Given the past record of Mali and the broad public consensus in favor of the reform program, the Board could be confident that the authorities would do their utmost to maintain the stance of the economic reform program. The authorities were aware of the downside risks to the program and they remained committed to resisting wage pressures. Moreover, they were prepared to take offsetting measures to correct any shortcoming in performance that might occur.

Mali had achieved significant progress with respect to the privatization program and the reform of the public enterprise sector in 1996, Mr. Barro Chabrier considered. Despite the delays that had been encountered, which were attributable to factors beyond their control, the authorities intended to strengthen their efforts over the coming year to privatize and rehabilitate the remaining public enterprises, including the insurance company, CNAR, and the national tobacco company, SONATAM. In that respect, it should be borne in mind that many public enterprises had already been privatized in Mali.

He agreed with Mr. Fontaine on the need to address trade policy issues in a regional context, Mr. Barro Chambrier commented. Under the two-pronged approach currently followed by the staff, which entailed consultations both at the regional level and with individual countries, it was usually possible to reconcile the various objectives of countries in the region.

The Malian authorities recognized that difficulties had been encountered in the implementation of the public investment program during 1996, Mr. Barro Chambrier stated. The authorities had clearly identified the problems involved and they were taking steps to address them.

Despite the successful progress achieved by Mali in its adjustment efforts thus far, the timely availability of external assistance would remain critical to its pursuit of economic development and sustainable growth, Mr. Barro Chambrier commented.

The Executive Board took the following decision:

1. The government of Mali has requested the second annual arrangement under the Enhanced Structural Adjustment Facility.

2. The Fund has appraised the progress of Mali 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/97/38.

3. The Fund approves the second annual arrangement set forth in EBS/97/65, Supplement 1.

Decision No. 11486-(97/42), adopted
April 21, 1997

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/97/41 (4/18/97) and EBM/97/42 (4/21/97).

4. TANZANIA—ENHANCED STRUCTURAL ADJUSTMENT FACILITY—REVIEW UNDER FIRST ANNUAL ARRANGEMENT

1. The government of Tanzania has consulted with the Fund in accordance with paragraph 2(d) of the first annual arrangement for Tanzania under the Enhanced Structural Adjustment Facility (ESAF) (EBS/96/165, Sup. 1, 11/12/96).

2. The letter from the Minister of Finance of Tanzania dated March 27, 1997, shall be attached to the first annual ESAF arrangement for Tanzania, and the letter from the Minister of Finance dated October 18, 1996, together with its annexed Memorandum on Economic and Financial Policies and tables, shall be read as supplemented and modified by the letter of March 27, 1997.

3. The Fund determines that the midterm review contemplated in paragraph 2(d) of the first annual ESAF arrangement for Tanzania has been

completed and that, notwithstanding paragraph 2(b)(i) of the arrangement with respect to the retrenchment of 10,000 civil servants by end-December 1996, Tanzania may request disbursement of the second loan specified in paragraph 1(c)(ii) of that arrangement. (EBS/97/63, 4/8/97; and Sup. 1, 4/15/97)

Decision No. 11487-(97/42), adopted
April 18, 1997
effective April 21, 1997

5. ANNUAL MEETINGS—GOVERNORS' PER DIEM ALLOWANCE

The Executive Board approves the recommendation contained in EBAP/97/35 regarding per diem allowances for Governors and Alternate Governors during attendance at meetings of the Board of Governors.

Adopted April 18, 1997

6. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 95/110, 95/114, and 96/3 are approved.

APPROVAL: October 24, 1997

REINHARD H. MUNZBERG
Secretary