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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/76

10:00 a.m., July 23, 1997

Contents

Executive Board Attendance

S. Fischer, Acting Chairman

Executive Directors

A.A. Al-Tuwaijri
M.-A. Autheman

T.A. Bernes
B. Esdar
E.R. Grilli

D. Kaeser

W. Kiekens

G. O'Donnell

M.R. Sivaraman

G.F. Taylor

J. de Beaufort Wijnholds

Y. Yoshimura

A.G. Zoccali

Alternate Executive Directors

M.F. Melhem, Temporary
A. Fayolle
H. Paris, Temporary
C.X. O'Loghlin

J.P. de Morais
J. Mafararikwa, Temporary

H.F. O'Brien
J. Jonáš, Temporary
N. Goffinet, Temporary
B.S. Newman
S.D. Melese-d'Hospital, Temporary
M. Dairi
M.-H. Mahdavian, Temporary
S. Rouai, Temporary
A. Vernikov
E. Kouprianova, Temporary
L. Palei, Temporary
J. Shields
Y.Y. Mohammed
M.H. Elhage, Temporary
G.M. Iradian, Temporary
H.B. Disanayaka
R.P. Watal, Temporary
B. Andersen
M.A. Cilento, Temporary
J. Guzmán-Calafell
E. Rodríguez, Temporary
Y.G. Yakusha
L.B.J. van Geest, Temporary
A. Barro Chambrier

S. Joyosumarto
Han M.
Zheng H., Temporary
J.A. Costa, Temporary
O. Otazú, Temporary

R.H. Munzberg, Secretary
A. Mountford, Acting Secretary
M.M. Cuc, Assistant

Also Present

IBRD: J.A. Katz, A. van Trotsenburg, Africa Regional Office; H.-O. Moritz, E. Somensatto, Europe and Central Asia Regional Office; E. Bell, South Asia Regional Office. IDB: I. Kaylin, Office of the Presidency. African Department: A. Basu, Deputy Director; M.T. Hadjimichael, N. Kirmani. Asia and Pacific Department: A. Chopra, M.R. Kelly, K. Kochhar, A.A.F. Op de Beke, C. Senivongs. European I Department: M.C. Deppler, Director; Y. Horiguchi, Deputy Director; C. Beaumont, G. Belanger, L.D. Everaert, A.K. McGuirk. External Relations Department: S. Nardin, L. Wallace. Fiscal Affairs Department: M. Cangiano. Legal Department: W.E. Holder, Deputy General Counsel; R.C. Baban, H. Elizalde. Monetary and Exchange Affairs Department: A.-M. Gulde. Policy Development and Review Department: J.T. Boorman, Director; T. Leddy, Deputy Director; A.R. Boote, D. Burton, C. Daseking, T.W. Dorsey, M.E. Dow, O. Havrylyshyn, K.H. Kang, K.J. Langdon, A.T. MacArthur, C. Puckahtikom, D.C. Ross. Secretary's Department: P. Gotur. Treasurer's Department: D. Gupta, Deputy Treasurer; A.W. Lake, P.R. Menon. Western Hemisphere Department: E.A. Faal, S.P.O. Itam, R.K. Rennhack. Office of the Managing Director: H.L. Mendis. Advisors to Executive Directors: P.M. Fremann, A. Giustiniani, C.M. Gonzalez, K.M. Heinonen, R. Kannan, H. Mori, H. Ogushi, O. Sein, T. Turner-Huggins. Assistants to Executive Directors: T. Berrihun, J.G. Borpujari, P.I. Botoucharov, K.S. Brownlee, J. Chelsky, H.W. Cocker, D.A.A. Daco, J.C. Estrella, D. Fujii, S. Fukushima, W.K. Gruber, R.J. Heinbuecher, J.K. Honeyfield, E. Jourcin, K. Kask, K. Kpetigo, T.-M. Kudiwu, Lai K., F. Mercusa, D. Merino, A.R. Palmason, Phan M.H., L. Pinzani, T. Presečan, Qi J., E.T. Rădulescu, J. Roaf, O. Schmalzriedt, T.T. Schneider, U.Y. Tilyayev, E.L. Zamalloa.

1. INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—ESTIMATED COSTS AND BURDEN-SHARING APPROACHES

The Executive Directors considered a staff paper on the costing of the Initiative for Heavily Indebted Poor Countries (HIPC) and approaches to burden sharing (EBS/97/127, 7/7/97; and Sup. 1, 7/17/97). They also had before them the Paris Club Chairman's summary on the burden-sharing issue (EBD/97/92, 7/23/97).

The Director of the Policy Development and Review Department made the following statement:

> The Paris Club has held extensive discussions on burden sharing, before and since the staff paper issued on July 7. The Paris Club met on July 15, and consulted with its members afterward with a view to preparing a statement which would convey the Club's position on burden sharing under the HIPC Initiative. This document, dated July 15, which was the date of the meeting, was received by the Fund staff yesterday afternoon.
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> Directors will have been able to see it only at the last minute. It is a rather nuanced document. I have had some discussions with my own staff who attended those meetings, and also with the Chairman of the Paris Club, seeking his commentary. Obviously, we would very much appreciate whatever comments the representatives of Paris Club creditors in the Board can offer in the course of the discussion.
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> The first paragraph of the statement contains nothing substantially new. It reaffirms the general principle of providing debt relief, up to the equivalent of 80 percent of reduction in net present value of debt on a case-by-case basis. The second paragraph restates the Paris Club position, as has been echoed by a number of representatives of Paris Club creditors in the Board: creditor action should occur only in the context of proportional action by multilaterals. This, of course, has been a point of contention between the Paris Club position and the position elaborated by management in the initial proposals and in its response last September to the first communication from the Paris Club.
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> But, very important, the second paragraph recognizes that the basis for calculating the proportionality is the net present value of debt reduction after Naples terms. In other words, Naples terms is the base, and measuring and assessing proportional action by the various creditors would be done on the basis of debt relief provided after the application of those Naples terms.
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> The third paragraph says that, if proportional action by all creditors up to 80 percent by the Paris Club and then matching action by the others, including the multilaterals, does not ensure sustainability, all creditors should consider appropriate solutions. This could, the document goes on to say, include additional action by multilaterals, even though the document also recognizes the financing constraints that the multilaterals face, and suggests

that Paris Club creditors could also reconsider the *assiette* or the coverage of the debt upon which relief has been granted.

My interpretation relies on the context of the last phrase that says "within the agreed framework of the Paris Club" which I interpret as a suggestion that the Paris Club would wish to adhere to its principle of not going beyond 80 percent, but would be willing to look at the coverage of the debt to which those terms are applied. That could involve including possibly some ODA; it could possibly involve reconsideration of post-cutoff-date debt. Such measures would increase the effective relief.

The view of the Chairman of the Paris Club is that this will permit successful operations under the initiative in the vast majority of cases. For the few remaining cases the issue under Paragraph 3 would need to be reconsidered. The letter does not suggest a defined posture which would indicate exactly what the solution would be, but it certainly opens the door to a solution not dissimilar to the proportional approach outlined in the staff paper.

Mr. Kaeser made the following statement:

We thank the staff for providing us with revised estimates of the potential cost of the HIPC Initiative. We welcome its efforts to reach as realistic and conservative figures as possible. As the staff points out, these results are tentative and subject to change. They, nevertheless, convey important information for our discussions on the use of ESAF resources and on the financing of future ESAF operations. We would, therefore, encourage the staff to pursue this effort, updating the estimated costs whenever an important modification occurs.

The estimates presented in the paper highlight the high uncertainty surrounding such an exercise. In June 1996, the potential costs of the HIPC Initiative amounted to $5.6 billion, in Spring 1997 to $8.4 billion and today the figure would stand at $7.4 billion. The broadened eligibility stemming from the adoption of the management guidelines has of course contributed to these higher costs. Modifications in the framework of the initiative explain, however, only part of this outcome. The variability of the results also has to be attributed to new information and changes in some important assumptions.

While we agree with the working assumptions adopted in the paper for costing purposes, this does not prejudge our position in future Board discussions regarding the eligibility of individual countries, the date of the completion point (with respect to Guyana and Mozambique for instance) or the NPV of debt-to-export targets. This applies in particular also to the use of a NPV of debt-to-export target of 200 percent for estimating total costs of the initiative. As we mentioned in earlier discussions, we do not agree that the recommended target range be clustered toward the lower end of the agreed 200–250 percent. An average outcome for the NPV of debt-to-export ratio of 220 percent should be more realistic.

When designing the initiative, one preoccupation was to maintain the preferred creditor status of multilateral financial institutions. At the same time, there was a need to provide a credible signal that these institutions were ready to assume their share in debt reduction. The solution we found at that time was to combine a sequencing in creditors' interventions with a strong commitment at the decision point. Bilateral and commercial creditors would move first, while multilateral institutions would only step in at the completion point. This sequencing was thought to preserve the preferred creditor status of these institutions. At the decision point, however, multilateral institutions as well as bilateral creditors would commit themselves to reduce their claims by a certain amount. We think that this structure is still the appropriate one. We therefore see no reason why multilateral and bilateral interventions should be done simultaneously as the paper seems to suggest. This would be in contradiction with the spirit of the HIPC Initiative and with the preferred creditor status of multilateral financial institutions. Institutions willing to provide additional support during the second phase should not, however, be prevented to do so.

Concerning burden sharing, we cannot accept the so-called Paris Club proposal where assistance beyond 80 percent NPV reduction should all be provided by multilateral creditors. This would contradict the preferred creditor status of multilateral financial institutions, and would, furthermore, leave all the assistance beyond 80 percent NPV reduction needed to reach a sustainable debt burden (in the Range 2) to the sole responsibility of the multilaterals. Neither can we support the fully proportional burden-sharing approach suggested by the staff, where the costs would be equitably shared among the different creditors whatever the level of assistance. Following the proposals made at the Lyon summit, the Paris Club creditor countries have agreed to provide NPV debt reduction up to 80 percent on a case-by-case basis on eligible debt, and they should keep this commitment. If the action of bilateral creditors is insufficient to achieve a sustainable debt position at the completion point, then the multilateral creditors should step in. The costs for multilateral institutions should, however, remain proportional to their exposure.

We suggest to adopt the Modified Residual Approach. Following this approach, additional proportional action from all creditors may in some cases be needed to achieve a sustainable debt position. In these cases, bilateral creditors would be required to provide more than 80 percent NPV reduction on eligible debt. We recognize that this will probably be difficult to obtain without new terms being established. We would, therefore, encourage the staff of the Fund and the Bank to further explore with the Paris Club alternative possible means to provide additional assistance (e.g. increasing the coverage of debt subject to the 80 percent NPV reduction or forgiveness of ODA). Unless these additional means deliver sufficient assistance, multilateral creditors will be forced to intervene more than proportionally. In this case, however, bilateral creditors will save little, since the higher costs faced by multilateral institutions will have to be financed through additional bilateral contributions.

Finally, we do not support the suggestion that Paris Club debt relief provided under the Naples terms be taken into account in the calculations of burden sharing. First, Naples terms have been granted up to now in the absence of action by multilateral creditors. Second, Naples terms were agreed upon before the initiative was launched and cannot therefore be considered as an additional mechanism. Neither do we agree to suggestions that other bilateral assistance (e.g., aid or contributions to the HIPC Trust Fund) be counted as assistance under the initiative.

Mr. Autheman made the following statement:

I welcome the opportunity to discuss the revised estimated costs and also the fact that this discussion appears to have helped bring the views of multilateral and Paris Club Directors closer on the issue of burden sharing. Therefore, I expect that the Board will now be able to work without its debates being poisoned by unsettled divergences.

The cost estimates need to be approached with a lot of care. There are many uncertainties. It is quite striking to see that the bulk of the increased cost estimate relates to the update of data which were not previously available. These revised figures are an order of magnitude and should not be considered a final estimate.

Another reason for caution is that the staff has had to work on a reference list, which should not be considered a pre-eligibility list. The agreed process for assessing the eligibility remains unchanged. There is a clear risk that the cost may be higher than initially thought, and more specifically that the cost for the Fund may be higher than initially envisaged.

However, we should not overplay that risk, because there are clearly several factors which can lead to a final cost much closer to the initial estimate. The most important ones, in my view, are the fact that, probably, not all countries potentially eligible will meet the conditionality standard which we have set and which is quite high, or many of them will meet them with a long delay. The second factor is that the Board's initial discussions show that sustainability can be achieved without in all cases going to the 200 percent threshold. So, my sense is that the risk of a higher cost is still manageable.

However, in two specific occurrences it raises a problem. The Fund cannot delay indefinitely negotiation on the financing of a permanent ESAF and the HIPC Initiative. For the African Development Bank, the cost estimate which comes out of this paper is clearly not consistent with the need to protect the integrity of this weak institution.

Turning now to the matter of burden sharing, my authorities consider that decisive progress has been achieved to find common ground. The analysis provided by the staff of the Fund has shown that the cases where the 80 percent ceiling can be inconsistent with the achievement of debt sustainability are limited enough for all creditors to try and find a solution on a case-by-case basis.

I have no disagreement with the interpretation given by Mr. Boorman, who rightly emphasized the tradition of good faith, which has always governed the relationship between the Fund and the Paris Club. I think that the commitment to contribute to the search for an appropriate solution is genuine and must be interpreted as giving the Fund confidence that, in the few cases where there still is a difficulty, it will be possible to design appropriate solutions on a case-by-case basis.

Mr. O'Donnell made the following statement:

I can be brief, because I agree very much with the points made by Mr. Autheman and Mr. Boorman. I would like to thank the staff for the paper which addresses some complex issues very clearly and pragmatically, and also thank them for their difficult work with the Paris Club. In my view, the solution described in the note that has been circulated is very sensible.

We always endorsed Option 3 of the staff paper, which is the full proportionality one, that endorses the joint nature of the initiative. Relations between the IFIs and the Paris Club have always been good and I hope we can continue that for the future.

I would stress one of the points Mr. Autheman made about not overemphasizing the importance of the exact arithmetic of these costings, because they will change. Uganda serves as an example of how the costings exercise can change quite radically, and in both directions. The idea that all costs always rise when we reconsider data certainly is not true for Uganda. If you look back, there were times when you looked at numbers of $500 million yet we ended up with $350 million. So, it depends upon the facts of the case, on the levels of debt, exports, etc., as well as decisions that we make about appropriate debt export target ratios.

So, having said that about costs, it is quite clear, looking to the future, that we will need to go back to the issue of determining the funding of the Fund portion of the debt. I think that will become a matter of urgency toward the end of the year, and I look forward to an equally clear paper which will handle that issue at an appropriate moment.

One final point to make, on Mozambique. Mozambique is one of those countries that quite clearly needed special action: First of all was Russian membership of the Paris Club, which I very much welcome and it will help enormously in terms of sorting out the very large debts. Second, of course, is that Mozambique is one of those rare cases where we need to consider how to go further forward.

I support Mr. Boorman's interpretation that probably what we are talking about is the Paris Club considering the assiette further. There are very few countries where we have to actually handle this issue, but there are one or two where it is important, because 80 percent does not get us all the way and we will need to be flexible and adopt a case-by-case process, and that seems to be what is happening. So, I am very pleased about the way this is going forward, and I very much welcome the steps made by the staff and the Paris Club.

Mr. Kiekens made the following statement:

Today's review by the Board of the updated costs for the HIPC and its distribution among multilateral and bilateral creditors comes none too soon. The Fund and the World Bank should demonstrate good governance by only deciding on potentially costly ways of implementing the initiative after careful assessment of the additional costs and how they can be financed. It is worrisome that although the basic features of burden sharing among different categories of creditors were proposed over 15 months ago, a substantial divergence of views has re-emerged between bilateral and multilateral creditors.

I agree that the results of the updated cost estimates must be interpreted with caution because they are subject to change. I take note of the staff's assertion that these estimates are conservative and thus more likely to overestimate the costs. Still, it should not be ruled out that the updated costs might prove to be underestimated. The large uncertainty surrounding the costs of the HIPC provides no excuse for over-generous implementation, nor for a reluctance to provide the necessary funding. It is the duty of the Board to perform its task as Trustee of the HIPC Trust with care and caution. A Trustee cannot commit the Trust beyond its financial means.

The Board has decided, in principle, that the targeted sustainable debt to export ratio should mostly fall in the lower half of the 200-250 percent range. The staff estimates the cost of this decision at about $1 billion; all figures I will now cite are given in 1996 dollars. The use of the three-year retrospective export average is also estimated to a cost of an additional $1 billion. The broadening of the debt sustainability criterion to include fiscal parameters adds another $700 million.

However, the staff also concludes that full application of the traditional debt relief mechanism justifies reducing the estimated cost of $500 million. Finally, shifts in the assumptions on the rate of export growth bring about major changes in the estimated costs. For instance, lowering export growth by 2 percent increases the cost by $1 billion. In sum, the staff now assumes $1.8 billion or a 32 percent increase over the figures 12 months ago. This is letting aside, of course, any issue of burden sharing.

However, this increase does not appear to touch the Fund since the staff holds the Fund's share constant at $500 million or, to use our normal yardsticks, SDR 800 million on an as-needed basis. In contrast, the World Bank and the multilateral development banks will see their costs increase by a startling 71 percent and 62 percent, respectively, and this, I insist, without any increase due to the changes in the burden sharing.

I would like to point out that these increases assume, as I said, no increase in the burden sharing. I would like to learn from the Fund why the Fund costs remain constant while that of all the other multilaterals increase dramatically. I would also like to ask the staff to accompany its paper giving the estimated cost to each creditor broken down by beneficiary countries, accepting, of course, that individual country estimates are even more subject to error than the aggregated costs.

Finally, since the implementation of the initiative requires a consensus of all bilateral and multilateral credit groups, I would like to know how the Paris Club and the other official creditors feel about the 22 percent increase in their costs resulting from recent Board decisions on how to implement the initiative. In order to avoid another unpleasant divergence of views, I strongly recommend seeking their formal acceptance of these Board decisions.

I come now to issue of burden sharing between the multilateral institutions and the Paris Club. The joint proposal of the World Bank and the Fund on this subject has always been clear. Its purpose was to preserve the preferred creditor status which has been consistently confirmed by this Board and most recently by the Interim Committee in September 1996.

As observed by Mr. Asser of the Legal Department in his contribution to the current legal issues affecting the central banks, Volume 2, the Fund's preferred creditor status consists of two elements. These are, and I quote, "first, the permission granted to the debtor country by its official creditors, the Paris Club, and its commercial creditors, to continue debt service payments to the Fund during rescheduling negotiations even while debt service payments to those creditors are suspended; and second, the agreement of those creditors that, unlike other creditors, the Fund need not participate in debt reduction operations."

Consequently, the Fund should not provide debt relief unless bilateral creditors have first agreed to 100 percent debt relief. This is consistent with the treatment of preferred, as opposed to unprotected, creditors in bankruptcy proceedings. Nonetheless, in the spirit of concession, the Fund and the Bank proposed extending debt relief on their claims in order to achieve debt sustainability after the bilateral creditors have agreed to relieve their qualifying HIPC debtors of up to 90 percent of those creditors' claims.

The common program of action of the World Bank and the Fund of September 21, 1996 contained only one additional proviso, and I quote, "that the debt relief by the multilaterals in proportion to the net present value of their claims should not exceed the debt relief by the bilateral creditors in proportion to the net present value of their claims after full implementation of the current available debt relief mechanisms;" this was the Naples terms, of course, which I am glad to see now that the Paris Club reconfirms.

If this would occur, which is more likely if Paris Club creditors only had to accept debt relief of up to 80 percent, a possibility already considered in the common Bank/Fund document of September 21 last year, the common document considered, and I quote again, "further discussions with the Paris Club creditors would be necessary to find alternative modalities consistent with the basic principles of the initiative, protection of the preferred creditor status of the multilateral institutions, in particular."

The Paris Club has considered this common paper. In its decision concerning this proposal of September 21, their decision was communicated by the Chairman in a letter of September 28 to the Chairman of the Interim Committee, and I quote, "as a result of our most recent discussions following the commitment by the Fund and the World Bank," and these were the Board decisions taken just before that, "the Paris Club is ready to provide debt reduction of up to 80 percent."

The Paris Club creditors did not reject any other aspect of the joint World Bank/the Fund proposal which they had before them, nor did they refer to any need for further discussions. On the contrary, the Paris Club Chairman considered that the acceptance of the 80 percent ceiling signaled an understanding between his members' Club and the multilateral creditor institutions. Indeed, he closed his letter as follows: "I am convinced that this breakthrough fully responds to your expectations as well as those of all creditors and debtor countries concerned. I believe that all creditor countries will make the necessary efforts to ensure its prompt and ambitious implementation in order to contribute to the sustainable financing of the poorest and most indebted countries."

This letter enabled the Interim Committee, during its meeting the next day, to welcome the indication that the Paris Club creditors are ready to go beyond Naples terms in providing debt reduction of up to 80 percent. It also reaffirms the importance of the Fund's preferred creditor status, and the Committee requested the Executive Board to proceed quickly with the implementation and to report on progress.

My interpretation of the history of the negotiations between the Paris Club and the multilateral creditors and of the implementation practice is that it was agreed that the Paris Club creditors would provide, first and exclusively, debt relief of up to 80 percent to be followed by additional debt relief provided exclusively by the multilateral creditors in an amount sufficient to reach debt sustainability. The only pending issue on which further negotiations are necessary are cases where multilateral creditors would provide more debt relief in proportion to their claims than the bilateral creditors have provided over and above Naples terms. I therefore cannot accept the latest Paris Club proposal that their debt relief of up to 80 percent is conditioned on the simultaneous taking of proportional action by the multilateral creditors.

What must we conclude from all of this? The statements of Mr. Autheman and other colleagues that the Paris Club behaves in good faith, have to be qualified. I request the Fund staff to continue negotiations with the Paris Club based on a bona fide interpretation of the agreements reached on September 28, and to try to continue to reach an agreement on those cases where 80 percent debt relief by the Paris Club and consequential debt relief by the multilateral institutions risk leading to more debt relief by the multilaterals above the bilaterals. I think that the latest information we received from the Paris Club gives some opening for such negotiations, and I hope that the Fund and the World Bank staff will be successful in this.

The Director of the Policy Development and Review Department said that, regarding the ongoing effort to raise the resources in the context of both the interim ESAF and the HIPC Initiative, Mr. Kiekens was correct that the Fund had established targets within the SDR 2.5 billion for subsidies. On an as-needed basis, the staff estimated that, for the interim ESAF, SDR 1.7 billion would be required, and for the HIPC Initiative, SDR 0.8 billion. The staff paper contained an up-to-date estimate of the costs expected under the HIPC Initiative. The SDR 0.8 billion incorporated into the target for the ESAF/HIPC Initiative had been based on the June 1996 estimates. The staff did not wish to suggest that the figures would not change—the ultimate cost remained uncertain—nor did it propose that the Fund's contribution be frozen at the original figure of SDR 0.8 billion. The Fund had committed itself to participating in a particular way in the initiative and would need to find the resources to be able to fulfill that commitment.

Mr. Autheman stated that his recollection of the Fund's communications with the Paris Club differed from that of Mr. Kiekens. At the time the Paris Club had agreed to raise its debt relief from 67 to 80 percent, three matters had remained unresolved: First, the Paris Club had declined to provide debt relief beyond 80 percent of net present value of debt claims; second, the Paris Club had wished to retain the right to claim that debt relief between 0 and 67 percent could count as part of its share of the burden—those two issues had since been settled. The third issue had concerned the insistence of the Paris Club on a fully proportional approach, on which there had been disagreement with the staffs of the Fund and the World Bank. The latest display of understanding from the staff on that matter was welcome. In no way should the past disagreements be attributed to bad faith.

Mr. Kiekens noted that the two concerns of the Paris Club mentioned by Mr. Autheman—the fully proportional action by the Fund and the Paris Club, and the question of whether burden sharing should reflect relief provided on Naples terms—had not been mentioned in the Paris Club Chairman's letter announcing an agreement and indicating that all issues had been settled. Also, the following day the Interim Committee members had reconfirmed the Fund's preferred creditor status. Furthermore, cost estimates prepared by the staff had been inconsistent with an interpretation that the burden sharing should take into consideration all the efforts made by the Paris Club creditors before Naples terms. For those reasons, he continued to stand by his interpretation of the events.

Mr. Yoshimura made the following statement:

> I appreciate the staff's efforts in revising the estimates of the potential costs of the HIPC Initiative. The staff has provided not only estimates of the overall costs but also a multilateral/bilateral breakdown of costs, in particular, costs for the Fund and the Bank.
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> It should be noted that these estimates are based on extremely conservative assumptions of countries' situations: for example, all countries which are potentially eligible for the HIPC Initiative are assumed to request assistance; all countries are assumed to implement adjustment programs with good faith; and the second stage is assumed to be reduced to one year for Bolivia, Guyana and Uganda, and to two years for Burkina Faso and Mozambique. However, application of the HIPC Initiative is determined on a case-by-case basis according to the rigid four criteria, and therefore such a universal application with many cases of a shortened second stage may not be

justified. In this context, we have to keep in mind that the estimates are made for the sake of precaution, and that they must not be taken as entitlement to the HIPC Initiative. In fact, the estimate of overall costs has already been reduced because of various changes in the situation since last April, such as prospects for higher exports and revenues.

At the same time, however, I certainly understand the concern expressed in Mr. Boorman's and Mr. Williams's memorandum of July 10 that the total amount of the financing for the HIPC Initiative will increase as bilateral contributions are delayed and potential interest earnings from them are lost. In this regard, my authorities have reconfirmed that we are prepared to provide grant resources within the amount of our contribution to SCA-2 on an "as needed" basis without any strings attached.

On burden sharing between the bilateral and the multilateral creditors, I basically think that both sides should contribute to debt reduction simultaneously and proportionally. In this respect, the Paris Club or Fully Proportional approach looks more reasonable to me for providing up to 80 percent NPV debt reduction. When additional efforts are needed to reach debt sustainability, all creditors should consider appropriate solutions. Given the important efforts made by Paris Club creditors to provide up to 67 percent NPV debt reduction, solutions could include additional contributions by the multilateral creditors, taking into account their financial constraints.

Finally, I would like to touch upon the issue of the preferred creditor status. The implication of the preferred creditor status for the multilateral creditors, according to my understanding, is that the status of the multilateral creditors should be respected by their being given priority to receive repayments over the bilateral creditors. However, I am not sure if this means that the multilateral creditors are assured of less credit reduction than the bilateral creditors. I also understand that the preferred creditor status for the multilateral creditors has no legal foundation but, rather, is conventional in nature. What is important in essence for the multilateral creditors, including the Fund, to maintain their preferred creditor status to the debtor countries is to show their catalytic role when the financing program is formulated among various creditors both public and private. If multilateral creditors continue to be effective as catalysts, debtor countries would prefer to repay them rather than bilateral creditors even though the former provide a larger amount of debt reduction. In this regard, I think that there may be room for a more flexible interpretation of the preferred creditor status for the multilateral creditors in cases where it is necessary.

Mr. Newman made the following statement:

Like previous speakers, I also welcome the staff's paper, which has served to clarify issues and energize action on the part of all parties.

The central issue in this debate has always been how you share the burden amongst creditors, although I must admit I find a little artificial the distinction between bilateral creditors and multilateral creditors. The same countries serve as creditors in both cases simply changing their hats from bilateral to multilateral. In this context, it was clear from the outset that management's definition of the preferred creditor status of the institution and its reflection in the residual approach was never accepted by the actual creditors to the institution when they wore their Paris Club bilateral hat versus when they wore their multilateral Fund hat. My reading of history is a lot closer to Mr. Autheman's than Mr. Kiekens's, in terms of the debates that we had in this Board and the clear statement by the Paris Club creditors that they did not accept the residual approach from the outset.

Similarly, I understand the concerns that were expressed by the Fund and Bank to the original Paris Club approach, which set a cap of 80 percent and then had the institutions pay the difference. The Paris Club creditors, when they wore their Fund hats, found that objectionable as well. Therefore, it seems to me that the staff's "third way" is a reasonable approach to reconciling the differing views of creditors when they wear their bilateral Paris Club hats and when they view the issue from a multilateral perspective. In that regard, I thought that the Paris Club approach that has now been presented, and which Mr. Boorman has described, as a reasonable way to move the exercise ahead. I will not try to define exactly what the Paris Club letter means. In all of these compromises, ambiguity can be highly beneficial in moving the exercise forward. It is fairly clear, however, that the Paris Club creditors are now willing to accept some kind of proportional arrangement in which they are prepared to consider on a case-by-case basis broadening the assiette. As you know, this chair has always been willing to broaden the assiette as a means of achieving a resolution that would ensure adequate debt sustainability and would also ensure that the costs were equitably distributed. Therefore, we consider this an important step forward. Moreover, we view the flexibility in the Paris Club approach as an asset rather than a disadvantage. I assume that the same wisdom and flexibility that the Paris Club creditors have shown in the recent past will be carried forward when they put on their Fund hats again.

However, it seems to me, if this exercise is going to be successful, it is essential that the Fund provide to the Paris Club—and to all of us, as we wear our other hats—more detailed information on the composition of the various cost estimates. We were struck, for example, by the degree of change in the total cost estimates for the HIPC Initiative during the past year, from \$5.6 billion in June 1996 to \$8.4 billion this spring and now to \$7.4 billion. We understand that the move to a three-year export average and the inclusion of debt to fiscal revenue ratios has affected the calculations, and these were change endorsed by the Board, and indeed almost initiated by the Board.

However, cost adjustments resulting from changes in underlying debt sustainability analyses, from a more detailed simulation of traditional debt relief mechanisms, and from higher export or revenue projections are too amorphous and inspire more questions than they answer. Simply put, I think we need more details on the costs than have been provided. In developing aggregate cost estimates, the Fund and Bank should also make available to the Boards the country-by-country estimates underlying the total, reflecting the best available nominal and NPV data on amounts of debt outstanding, by creditor, together with projected debt ratios through the completion point and potential NPV debt reduction. We also need data for Paris Club exposure, as the DSAs are prepared, by type of debt, in order to ensure the Paris Club can make rational decisions as it looks at each individual case.

We appreciate the staff's concern about the sensitivity of individual country information, but there is no reason why this information cannot be provided with a clear understanding that the data is preliminary and subject to change, that it will be updated in coordination with the governments involved, and that it does not pre-empt Board decisions on eligibility or target levels. Greater transparency of data would enhance understanding of the natural variability of factors affecting aggregate cost and strengthen support for the initiative. I think it is essential if we are going to proceed along the lines that the Fund and the Paris Club seem to be moving toward.

In closing, I would like to add that the costing aspects covered in the staff's paper throw into high relief the need to make some decision soon about financing the initiative. We are open to how these decisions are made. We have stated our position previously. It has not changed. We hope that this can be resolved as we move ahead in the exercise.

Mr. Guzmán-Calafell made the following statement:

Like others, I welcome this discussion on the estimated costs of implementing the HIPC Initiative, and on the possible approaches to allocate these costs among the different creditors. As a significant number of countries may reach their decision points in the near future, the importance of solving this issue promptly is gaining importance. Indeed, it would be unfortunate to delay the implementation of the HIPC Initiative by lack of progress in this area.

On the issue of total costs of the initiative, given the large margins of uncertainty and the sensitivity of the figures to modifications in the assumptions used, the staff's decision to base their analysis on conservative estimates is a reasonable one. After reading the assumptions in the report I was left with the impression that at the end the staff's estimates may prove to be on the high side. But the wide fluctuations in these estimates within a relatively short time span are a remainder that adhering to a prudent approach is the wiser route to follow. Having said this, I must admit that the scenario depicted in the paper is not a very comforting one. Not only are the cost estimates of the HIPC Initiative more than 30 percent higher than those prepared in June 1996, but the share that would need to be absorbed by multilateral creditors is also much bigger under any of the burden sharing options included in the report. For instance, in the June 1996 calculations, multilateral creditors were estimated to absorb 36 percent of the total costs of the HIPC Initiative. In contrast, under the most optimistic of the scenarios included in the paper for today's discussion, that is, the modified residual approach, the corresponding share would be 53 percent.

This leads me to the second issue raised in the report, i.e. burden sharing. The Program of Action on the HIPC Initiative endorsed by the Interim and Development Committees in September 1996, stipulates that the basic principles to which the assistance provided by multilateral creditors to this Initiative must adhere are: broad and equitable participation by all creditors, and the preservation of the financial integrity of the institutions and their preferred creditor status. While all the options presented in the report may be consistent with a broad participation of creditors, the case is not as clear-cut in the case of the other principles, and particularly regarding the issue of preferred creditor.

The most evident case is that of the so-called "Paris Club approach" described in the paper. As explained there, this approach implies a cap for debt reductions on NPV terms by Paris Club creditors of 80 percent, with multilateral institutions providing any additional assistance required beyond this level. In other words, whenever a reduction in the NPV of debt beyond the 80 percent level is needed, payments to Paris Club creditors have a priority over those to multilateral institutions. Accordingly, the burden sharing under this approach falls disproportionately on multilateral creditors. The staff estimates that the NPV reduction required to achieve debt sustainability under the Paris Club approach, as described in the report, would be equivalent to 23 percent of the net present value of claims of bilateral creditors and 29 percent of those of multilateral creditors. Even though there is no legal definition of the concept of "preferred creditor," the existence of due regard for the multilateral institutions' preferred creditor status cannot be justified in these circumstances. As explained by Mr. Boorman, the new version of the Paris Club approach circulated this morning contains a number of positive features. However, the extent to which it departs from the one included in the staff report is unclear. For instance, I have the impression that it still leaves open the possibility that multilateral institutions absorb the burden of the cost in some cases if debt reduction beyond the 80 percent level is required. If this is the case, the comments I made above would also apply here. But it would be useful to hear the staff's views on this.

The modified residual approach is consistent with the principles endorsed by the Interim and Development Committees, and therefore I can support this approach. According to the staff, the main disadvantage of following this route is of a more practical nature, namely, the risk that there is no agreement on burden sharing between multilateral institutions and the Paris Club, and thus that the determination of the discount to be provided to eligible HIPC countries be determined simply by the need to achieve a distribution of costs which is acceptable to both multilateral and bilateral creditors.

I can see that from a pragmatic viewpoint the fully proportional approach proposed by the staff may be a more feasible option. I have however one doubt. This option implies that debt relief to HIPC countries has to be provided equiproportionally and simultaneously by bilateral creditors and multilateral institutions. It is not clear that any preference is given to either of them, and therefore that a particular group is deemed as preferred creditor. The question is therefore to which extent the search for pragmatism would imply the sacrifice of an essential principle. I believe that to support this option, the Board has to be convinced that it is consistent with the preservation of the preferred creditor status of multilateral institutions. I would appreciate the staff's views on this.

Mr. Esdar made the following statement:

Like other colleagues, I would like to thank the staff for its updated estimates of the potential cost of the HIPC Initiative. We also appreciate that the supplement includes concrete information on the estimated cost for the African Development Bank and the Inter-American Development Bank.

There is no doubt—and this point has been made adequately clear in the paper—that the updated cost estimates are subject to a substantial margin of uncertainty and, in particular, are highly dependent on the underlying assumptions. Indeed, the fact that the cost estimates already deviate significantly from the April calculations signal that we have to be cautious in drawing concrete conclusions. While I acknowledge the indicative character of these calculations, I was nevertheless somewhat puzzled that the costs have been calculated on the basis of assumptions which at least in some aspects do not adequately reflect the discussions we have had before.

The so-called conservative approach, indeed, is very much on the generous side. It is crucial that we have to insist not only on a strict interpretation of the eligibility criteria, but also on a very strong program and adequate selectivity when deciding which countries qualify under the initiative. The last point has been especially emphasized by many colleagues when we discussed the performance under ESAF programs. In my view, selectivity is even more crucial for the HIPC Initiative, with successes closely linked to strong adjustment and reform.

I would like to give some examples where in my view the approach seemed to be a little bit too much on the generous side. I do not particularly like the word "conservative" in this regard very much. First, the paper correctly confirms that the countries which have been included in the estimates are included only for illustrative reasons and that the country coverage is not intended to prejudge the case-by-case Board decisions or to set any precedents. I strongly endorse this view. Indeed, when looking at some of those countries, there may be doubts whether they may qualify under the initiative, but we will have to come back on this question on a case-by-case basis.

Second, I was also somewhat puzzled by the assumption of a NPV debt export target of 200 percent for all countries. If I remember it correctly, the initiative is based on a target range between 200 and 250 percent, thus, the assumption of 225 percent, on the average, would be much more prudent and realistic. A more realistic approach in this regard would also be justified in order to balance the systemic underestimation of exports introduced earlier this year—for example, by excluding workers' remittances and by the backward-looking three-year average approach to calculate the export basis.

Third, I was also very surprised by the fact that a significant shortening of the second stage has been assumed in the calculations for Guyana and

Mozambique. Both countries have not been discussed in the Board. It was my understanding from former Board discussions that a shortening should be extremely exceptional. We have to avoid creating misleading expectations and setting wrong precedents.

In my view, the conservative calculations are too much on the generous side, as I mentioned before. The assistance to be provided under the HIPC Initiative has to be brought in line not only with the limited financial resources available, but also with the need to insist on strict interpretation of eligibility criteria as well as on strong and convincing adjustment and reform programs. However, it is also apparent that we have to get a clearer picture of the financial resources which are available.

In this regard, I would like to encourage my colleagues to urge their authorities to participate in the financing by providing bilateral contributions within or outside the framework of SCA-2. I already have informed the Board that Germany will contribute generously by an interest-free credit of around 400 million deutsche mark. This is about SDR 170 million. That is more than twice the German share in SCA-2. We will not support any financing solution which would relieve member countries from their responsibility to provide their adequate share in bilateral contributions. The option to optimize the Fund's reserves should by no means be regarded as an easy way out. As you all know, this chair is always very much concerned about moral hazard, and our concerns in this respective context are even stronger.

Let me now come to the question of burden sharing. First of all, we should not give the impression that the cost of the initiative for the multilateral institutions has increased only because of a change in burden sharing assumption. As Mr. Kiekens has reminded us, the major factors contributing to those cost increases are changes or new interpretations of the eligibility criteria such as the new establishment of fiscal eligibility criteria, as well as modifications in calculating the export base.

Regarding burden sharing, the Paris Club has always advocated the case-by-case principle. Therefore, in my view, it does not make much sense to develop complicated ex ante burden sharing schemes and models. I very much appreciate that the Chairman of the Paris Club has again explained the position of the Paris Club on the HIPC, and clarified some issues which have been somewhat controversial in the past. I very much share the view of Mr. Autheman that the question of burden sharing in particular cases will very much remain the exception. Given this statement of the Chairman, I would expect that, in a spirit of compromise, in those limited cases where there may be minor problems, there will be appropriate solutions for this purpose.

Mr. Morais made the following statement:

Like other previous speakers, I welcome the staff paper before us. The points discussed take the consideration of financing the HIPC Initiative an important step forward.

The work seems to me to rest on a limited number of cases as several HIPCs are not included in the cost estimates. Even those countries, such as Angola, which are considered to have sustainable debt positions on the basis of preliminary assessments, could, perhaps, present a different picture if it were possible to obtain more detailed information. Moreover, Liberia, Somalia and Sudan, countries which are among the worst HIPC cases, continue to be excluded. These three countries are facing extremely difficult debt situations as the data in the World Bank's Debtor Reporting System clearly show. I continue to believe that the Fund must look at ways in which it can help them effectively. As the staff has indicated, even for the countries included in the analysis, the cost estimates are subject to a substantial margin of uncertainty and are highly dependent on a number of important assumptions. Likewise, the debt situation in Liberia, Somalia and Sudan, as onerous as it is, merits some form of approach that accommodates shortcomings in data deficiency. It will be difficult for the initiative to be meaningful and credible as long as it fails to embrace these worst cases among the HIPCs.

We would favor much earlier decision points particularly for those countries in the last column of Table 1, for which the dates of 2000-2001 have been suggested. We also favor a lower NPV of debt-to-exports ratio as the assumed target of 200 percent could still leave a large number of countries in a situation that might not be much different from what they are experiencing now.

As regards burden sharing, the distribution of costs between bilateral and multilateral creditors shifts relatively little within each burden-sharing approach. However, the fully proportional approach appears to provide a middle ground relative to the other approaches, and could perhaps be used as a starting point to resolve the prevailing differences on burden sharing.

We attach great importance to an early full agreement on the issue so that the initiative could be put in place without long delay. If the situation demands, all creditors should be generous to go beyond the financing limits considered by the staff. A delay in the action by any one creditor could hold up other creditors' actions, further prolonging the plight of the HIPCs.

I noted with interest the staff's assumption regarding the treatment of the debt to the Russian Federation. The countries which are indebted to Russia, including those in my constituency, happen to be among the poorest. Therefore, Russia's cooperation to the extent assumed by the staff would play an important part in rescuing these countries from their present predicament.

Mr. Al-Tuwaijri made the following statement:

I thank the staff for a clear statement of the issues that must be addressed for the HIPC Initiative to go forward. Let me add a few remarks in that regard.

As the staff emphasizes, the cost estimates before us are subject to wide margins of error and sensitive to the numerous assumptions that have to be made. However, the trend clearly is upward. Thus, each of the alternatives presented in Table 6 implies a substantial rise in the Fund's share from that estimated in June 1996.

Regarding burden sharing, retention of the Fund's preferred creditor status must be the guiding criterion. In that connection, proportional participation is the farthest that the Fund should go. Therefore, I can support the staff's modified residual approach for burden sharing. I can also go along with the suggested fully proportional approach, if it helps in reaching a consensus.

It is fortunate that the HIPC Initiative can go forward in Uganda's case as debt sustainability can be reached without violation of either the proportionality criterion or the Paris Club's 80 percent NPV reduction cap. For the other countries, I hope the remaining issues will be addressed at an early date for the HIPC operations to proceed as scheduled.

I agree with the staff that a major premise of the HIPC Initiative was that it would build upon existing debt relief mechanisms. Therefore, assessment of burden sharing should not include arrangements already in place.

Ms. van Geest made the following statement:

I do not see a need to comment much on the staff's projections. The assumptions are in general conservative in the sense that they provide the upward end of the cost range. The assumptions on individual cases can be discussed when they come to the Board. Now I note the preference of some to go for higher targets, and this may be appropriate in some cases. However, the series of London, Naples and now Lyon terms should be a reminder that the creditor community has tended to overestimate the debt level at which countries can exit in a sustainable manner.

Our position on burden sharing is guided by three considerations. Preferred creditor status, ownership by all creditors and practical working rules.

First of all, any solution should honor the preferred creditor status of the IFIs in general and the Fund, as a monetary institution, in particular. Now interpretations of this idea vary around the table. Let me just recall that we belong to the stricter camp. Secondly, the HIPC Initiative is an effort on the part of all creditors to ensure an exit from debt rescheduling for those countries, that have shown sustained adjustment. Coordination between creditors is key, but this can only be expected if we opt for an inclusive approach. I therefore welcome the initiative to invite the IDB and the AfDB on relevant occasions. It also suggests that we should adopt a burden sharing formula that would foster ownership on the part of the Paris Club. Finally, we should come up with a rule that can be implemented in a practical manner. Staff and Board time are stretched as it is. Against this background, we can support the fully proportional approach in the spirit of compromise and pragmatism.

We have been trying to duck the issue of financing for some time now. However, the last tables in the paper clearly underscore that time is running out. The Fund's already somewhat dubious reputation in this area would become even worse, if it were unable to participate in HIPC operations because of liquidity constraints.

In addition, there is the issue of the total amount of finance needed. The staff's calculations are obviously open to wide margins of uncertainty. Nevertheless, the overall costs of the initiative have drifted upwards and the burden sharing rule has become less advantageous to the Fund. However, financing of the ESAF-HIPC Trust has remained as tight as ever. Indications of bilateral contributions so far do not provide a lot of leeway. In fact, delays in the refunding of SCA-2 erode the purchasing power of some of the commitments, complicating matters even further.

Obviously, I hope that the financing issue can be discussed in an early stage. This would also provide a good opportunity to discuss the investment strategy, we might like to adopt in the Trust. In the meantime, we might try to cushion the effects of delays a bit. With regard to the SCA-2 for instance, I was wondering whether one could not halt the erosion of SCA-2 based bilateral contributions by letting the SCA-2 accrue interest in one way or another. The staff's comments would be appreciated.

Mr. Grilli made the following statement:

From the reading of today's staff document, I have the clear impression that most of the ambiguities—and ambiguities to me always carry a negative connotation—and weaknesses that we have observed in previous Board meetings when we discussed the formulation of the HIPC Initiative have exacted a large toll in terms of costs. I am worried about it. The cost of the initiative, as now estimated, has increased very substantially, as Mr. Kiekens and others have pointed out. I am worried about the total burden, more than the distribution. The shoulders on which the burden is going to fall are, in fact, largely the same. We cannot really find much comfort in distinctions between the burden that will fall on the bilateral creditors and the burden that will fall on the multilateral institutions.

In light of the nature of the HIPC Initiative, it is normal that one should have expected a fair degree of uncertainty about its costs. We do not find that unexpected. However, what we found unexpected and worrisome is that the initiative was conceived, was modified, was shaped without having a clear picture of the costs associated with it, and, even worse, of the available financing. We have treated costs and financing quite loosely.

In addition, after a first decision on the establishment of an initiative, the eligibility criteria have been revised, and they have been substantially relaxed, thus making the cost picture larger and more uncertain. Decisions were made about technical assumptions without a clear notion of the cost to the institution. Would we have really decided that a three-year average was okay if we had known that it would have implied an increase of cost of $700 or

$800 million? I leave it to you to answer that question. It is a rhetorical question, though.

What we did was hardly optimal from a methodological point of view, and certainly striking as far as cost consequences are concerned. In comparison to the initial projections, the estimated total costs have changed from 5.6 to 7.4, with a range between 6.3 and 8.5 billion. The envisaged contribution of multilateral creditors has doubled from 2 to 4.3 or 4.7 billion. It is also worth noticing that a very large amount of this increase is due to the broadening of the eligibility criteria and another to the assumption about the exports.

We have often referred to the uncertainties related to the distributional burden, but some of them we introduced ourselves. We have made these decisions about changing the eligibility criteria, we have made these so-called technical decisions, but we did not know about the costs.

My overall impression from the estimates is that the notion of a firm budget constraint, which we thought was essential, seems to be losing much of its practical effectiveness. I think we have to react to that. The whole exercise cannot be based on a kind of the Say law in reverse; that is, that demand for financing creates its own supply. The logic of the exercise should have been the opposite: classical logic. First, you look at the resources that you have available, and then you look at the most productive way in which you can use them.

On the specifics of the paper, today's paper may be considered as the most precise effort and the most intensive effort made so far to estimate the potential costs associated with the initiatives. We thank the staff for that. Yet the paper is still very tentative in its conclusions. Witness the ranges that are arrived at. The results are subject to uncertainty, as many speakers have pointed out, and they are very sensitive to assumptions made, as many speakers have pointed out. But I am worried about that. That to me is not a cause for comfort. It is a cause for worry.

First, the exercise does not consider three countries: Liberia, Somalia, and Sudan. In light of what has happened so far, and in light of the objective situation in these countries, I would not be surprised if, in the not too distant future, the Board would not be called to discuss a further update of costs because of the incorporation in the initiative of some or all of these countries as well.

Second, the estimates presented in the paper are based on the assumption of a net present value of debt to export target of 200 percent for all countries. I do not want to repeat what has been said, but I am in agreement that, although made to estimate an upper limit for the costs, this assumption runs the risk of creating a self-fulfilling expectation that 200 percent is the target that we considered normal, which was not; we agreed that the target should be between 200 and 250 percent. That was the agreement, and we should avoid perhaps involuntarily giving the opposite expectation that 200 is the norm.

As it was emphasized just a few days ago in the discussion of the ESAF review, the Board will be well advised to exercise greater selectivity in providing Fund support. This is true of ESAF operations in general, but it is true also of the HIPC Initiative. Yet the ongoing process does not seem to go in that direction. Bearing in mind the results of the ESAF review concerning, for example, the weight of external debt in the growth process, it is striking that already 10 countries out of 20 considered in the paper are expected to reach the decision point this year. In addition, five of them are even regarded as having a track record of policies sufficiently strong to allow for a shortening of the second stage. In three cases, the shortening is soon to be physiological limits in two years. This implies, among other things, that about half the total potential costs will have to be decided upon and will fall within this year.

The exceptionality criteria for HIPC debt relief seems to have become, or seems to be on the way to becoming, quite unexceptional. Here, bear in mind, I am not talking about need, which of course is there; I am not talking about efforts of countries, which of course are there, although in different degrees; I am simply talking about resources that are available to meet those needs.

It is worth stressing also that the results presented by the staff are not likely to change anybody's capacity to finance the HIPC Initiative. Certainly, this does not change our capacity to contribute to financing it. I think that simply to say that now we have to look for financing is really to beg the issue. The issue is, really: do we have the means, and, if we do not, what we should do to introduce greater selectivity into the process, to look at the targets, to look at the target ranges, to look at the periods of performance, and to make sure that we have an initiative with viable financing arrangements.

That is the challenge. I do not think that we want to create expectations of debt relief that we cannot meet. If we did so, we would have only ourselves to blame. So, my plea is for honesty, of intense intellect and realism in looking at what we have available, and decisions which, whatever I might want, might have to be in the direction of scaling down some of the assumptions that we have made based on realistic assessments of the financing that is available.

Mr. Rouai made the following statement:

I thank the staff for the recent cost estimates of the HIPC Initiative and take note of their comments as well as those of other Directors with regard to the uncertainties surrounding these assumptions. At the outset, I wish to know whether the staff is aware of the position of the World Bank and other multilateral banks concerning the various proposals for burden sharing, since these institutions will bear the largest increase in cost estimates.

In the discussion on the HIPC Initiative, our chair is guided by two principles: (i) the continued support to the preferred creditor status of the multilaterals, in particular the Fund; and (ii) the debt sustainability target and assistance under the HIPC Initiative to be determined on the basis of country-specific assessments and not on burden-sharing considerations.

With regard to the various proposals for burden sharing, we support the modified residual approach endorsed by the Interim and Development Committees, as presented earlier by Mr. Kiekens. I wish to point out that under this proposal, as detailed in Table 6, the multilaterals will bear the whole burden of the increase in the cost estimate, as compared with the June 1996 figure. Their contribution will increase from $2 billion to $3.9 billion. The share of bilateral and commercial creditors will remain at $3.6 billion, with the cost for the Paris Club declining from $2.9 billion to $2.6 billion. Could the staff confirm my reading of these figures?

Finally, could the staff elaborate on the difference between the fully proportional approach and the recent Paris Club proposal? In addition, this approach raises the Fund's contribution from $0.8 billion to $1.2 billion on an as-needed basis. This is an increase of 50 percent, and I wonder if the staff could advise on how this amount will be financed, particularly in view of the delay in using the SCA-2 and gold sales.

Mr. Han made the following statement:

Being aware of the accurate costs of the HIPC Initiative by both the creditors and the indebted countries is very important to the start of the operation and also for success of the initiative. On the part of creditor countries, no matter what burden sharing approach will be finalized, the decision of debt reduction must be based on the right cost estimates. For the Fund, the size of the ESAF-HIPC Fund will also be basically determined by the estimates. On the part of the indebted countries, only the right cost estimates can ensure their debt relief on a sustainable basis.

We commend the staff for its efforts in updating the HIPC Initiative costs. It is necessary to have those strict assumptions to draw the estimated costs and many factors in these assumptions are subject to changes. We are also sympathetic with staff that it's very hard to get the most accurate estimates and they will change due to changes of projections over time. But if the estimates vary so much, say from US$8.4 billion three months ago to today's 7.4 billion, I am afraid they will lose much sense in helping or persuading relevant creditors to more actively participate in the HIPC Initiative, since people have every reason to wait for another three months and to see further big reduction in the estimates. It is therefore very much hoped that more work would be done in improving the way of data collecting and processing.

As regards the burden sharing approaches, we can go along with the third approach suggested by the staff. At the same time, I want to stress that the Paris Club members should make a firm commitment on their responsibilities in this regard.

On the issue of contribution under ESAF-HIPC trust fund, I think it is reasonable to count each individual country's contribution to ESAF-HIPC trust fund as a bilateral contribution under the initiative.

On the issue of debt relief by non–Paris Club members specifically for China, we have such a principle that we do not want to put an extra burden on those indebted countries. We will resolve the debt problems with the countries concerned through bilateral negotiations at the time convenient to both sides. The Paris Club terms can only be taken as reference for our consideration on this issue.

On the contribution by China under the HIPC Initiative, I just want to reiterate my authorities' intentions that my authorities have considered this issue very seriously and China will make its contributions according to its own situation and its capability, together with the consensus to be reached on the amount under the ESAF-HIPC Trust Fund.

Mr. Andersen made the following statement:

I want to express my appreciation for the staff's clear and concise paper. I fully realize that this exercise has not been easy to undertake and that the estimates presented in the report are subject to a substantial margin of uncertainty. I also welcome that the staff emphasizes that the results are not intended to prejudge the Board's future decision on individual cases, and I shall refrain from that as well.

On the burden sharing approaches, we very much welcome the efforts being made to provide the basis for reasonable solutions to this important issue and that clear progress can be reported in that regard. While experiencing considerable uncertainty regarding the financial contributions to the multilateral institutions, we are concerned about the share of the costs to be covered by the multilaterals. In this vein, we have a clear preference for the modified residual approach, which also would seem to be best in line with the importance we attach to the preservation of the Fund's preferred creditor status. In a spirit of compromise, we can also go along with the fully proportional approach, but do consider this only to be a second best alternative.

Mr. Zoccali made the following statement:

We join others in thanking the staff for attempting to provide the Board with a more precise estimate of the potential costs involved in the HIPC Initiative despite the uncertainties surrounding the exercise. As these are likely to be upper range estimates, the usefulness of updates should be taken in that light and issued only when either the circumstances or the working assumptions evidence a material change.

The ultimate objective of the HIPC is to ensure that the heavily indebted poor countries that have shown a sound track record of economic adjustment can attain a sustainable debt situation over the medium term. Reducing in a comprehensive and timely manner the overall debt burden of eligible countries to reinforce their efforts toward macroeconomic adjustment and structural and social policy reforms called for, from the outset, for a proper sequencing of creditors' interventions to maintain consistency with the preservation of the financial integrity and the preferred creditor status of the Fund and other multilateral financial institutions.

We see no compelling argument for abandoning the original sequencing under the Modified Residual Approach, which best coincides in our view with the traditional interpretation of the Fund's preferred creditor status, not least because of the limited potential for higher costs for the Fund. Moreover, it would be unfortunate if lingering differences on the burden sharing were to further delay the application of the initiative.

By concentrating exclusively on the burden-sharing costs of potential debt-reduction, we continue to disregard the basic problem of insufficient bilateral contributions, aggravated by the increasing opportunity costs for the Fund from the delay in the transfer of SCA-2 resources and postponement of gold sales and investment of profits; thereby limiting the availability of multilateral resources for the initiative which we all have supported. We had hoped that the current paper could have addressed both issues to close the financing gap. As noted by Ms. Van Geest, this matter cannot be ducked any further.

Having said this, the Fully Proportional Approach contains a number of positive elements, principally flexibility for case by case consideration and approximate midpoint results between the other two options. We could thus defer to the pragmatism of such an approach and go also along with it if only to facilitate a consensus.

Nonetheless, we join Mr. Kaeser in encouraging the staff of the Fund and the World Bank to further explore with the Paris Club alternative means to provide additional assistance by increasing coverage of debt subject to the 80 percent NPV reduction or forgiveness of ODA. We also don't consider that there is additionality to be derived from merely taking into account in the burden-sharing calculations Paris Club debt relief, under previous initiatives which have proved to be insufficient for bringing about debt sustainability in eligible cases.

Mr. Bernes made the following statement:

I would like to, first of all, join others in thanking the staff for a clear and concise paper. More than that, I would like to thank the staff for its tireless efforts in bringing forward unresolved issues for us to grapple with. This is an extraordinarily complex initiative, as we are all aware. I recall last fall a staff person remarking to me once this initiative was launched that it was going to be a very complex operation, bringing all of the various players in the various organizations involved. This individual expressed the hope that capitals would ensure that their spokesperson spoke from a similar line in each of the institutions; otherwise, it was going to be extraordinarily difficult to advance this initiative. Despite the fact that this hope has not been fulfilled, I think the fact that we have made as much progress as we have is testament to the sterling efforts of the Fund staff and a tribute to their effectiveness.

Like Mr. Autheman, Mr. O'Donnell and others, I think that the Paris Club communiqué does provide clearly a way forward, one that is based upon, as Mr. Autheman said, good faith and pragmatism, and I think that does allow us to proceed. I would just register three points. Firstly, one of the important aspects that came out in the staff paper is that debt sustainability targets should be based on specific circumstances of countries and not on burden sharing considerations. That is a point which we have argued from the start, and I welcome its clear recognition in the paper.

On preferred creditor status, like Mr. Yoshimura, I prefer a flexible and practical approach to this nonlegal issue. On cost and funding, as Mr. Autheman, Mr. O'Donnell, and others have remarked, the figures on the cost are going to be subject to some variance. There are a lot of uncertainties, and we are going to have to live with that.

On funding, this chair has for some time argued that we have to address that issue. Like Mr. O'Donnell, this is a question we will have to return to after the Annual Meetings.

Mr. Taylor made the following statement:

I would like to commend the staff for its continuing efforts in trying circumstances.

On the subject of cost, I have got nothing to add to the comments that have already been made by many people this morning. We must have a resolution of the burden sharing issue, and maybe Mr. Boorman's interpretation of the latest Paris Club piece of paper offers a way forward. Specifically, we would prefer the modified residual approach. Without reiterating the reasons for that, which have been expressed by a number of other Directors, we could perhaps accept a full proportional approach in an effort to find a consensus. In that respect, I would like reassurance from the staff that the latest Paris Club position is in fact fully consistent with the full proportional approach.

On the preferred creditor status, this may very well not be a legal matter and it may very well be capable of interpretation. One interpretation could be that provision by multilaterals of assistance lower or equal to that of other creditors would satisfy the principle. In that respect, I think Mr. Guzmán-Calafell asked some factual questions which need some response from the staff.

Preferred creditor status may not be a legal matter but it is a practical matter; it is a practical issue, because the IFIs do not have taxing power, whereas bilateral donors do. For IFIs that borrow in the market, their credit standing is surely critically important. So, I think in being flexible and practical, as Mr. Bernes suggested, we depend on the staff to assure us that any such pragmatic outcome is entirely fiscally responsible from the point of view of the Fund, and I would be interested to know from the Bank whether they are comfortable with this in relation to their position in the market place.

Finally, it is very difficult to go past Mr. Kiekens's observations about the responsibility of a Trustee. The Trustee should not commit beyond their means; it is a serious obligation. I do not suppose Mr. Grilli's reverse Say's Law is going to give us very much reassurance at all. The available resources for this exercise on the staff estimate will be fully committed before the end of the year, and in some respects our financing assumptions are going backwards. So, I do not suppose we are yet an emperor without clothes, but the suit coat is gone and by Hong Kong I suppose we will be down pretty close to the underpants. If the staff has any further thoughts on this matter, I would like to hear them.

Mr. Barro Chambrier made the following statement:

I welcome today's discussion, which is likely to narrow the gap on the views related to burden sharing. I would like also to compliment the staff for giving us updated costs despite the fact that full agreement has not yet been reached on the subject of burden sharing. I agree with the staff that cost estimates of this initiative are subject to a substantial margin of uncertainty, given the fact that the choice of target and timing varies from country to country.

On burden sharing in general, I believe that the best approach would be the one that takes into account the exposure of each creditor group. At present, the modified residual approach assumes that Paris Club creditors provide up to 80 percent net present value of debt reduction on eligible debt. If this 80 percent net present value of debt reduction is insufficient, multilateral creditors would provide sufficient assistance to achieve debt sustainability. I find this approach quite attractive, and I also agree with the staff proposal to favor a proportionate burden sharing. This approach would provide equiproportional assistance from bilateral creditors, while proportional multilateral action could be defined in comparison with the base of bilateral creditor action after application of Naples terms to all eligible debt.

On this latest point, I welcome the reaffirmation by the Paris Club of the basic principle of the initiative with regard to the proportionality and the flexibility. I am also encouraged by the fact that Paris Club creditors could also "consider carefully the appropriate assiette to achieve debt sustainability." In that connection, I would like to express my authorities' views that Paris Club creditors could consider the possibility of providing a greater than 80 percent net present value reduction on eligible terms and include the post cut-off date debt in the debt which is subject to 80 percent of net present value reduction to increase the level of effective debt reduction and reduce or forgive official development assistance debt.

Finally, countries in my constituency remain confident that an agreement on burden sharing will be reached at an early date in order to provide timely assistance to countries which are eligible under the HIPC Initiative.

Mr. Yoshimura stated that the content of the assiette was an issue for the Paris Club to discuss.

Mr. Autheman agreed with Mr. Yoshimura.

Mr. Joyosumarto made the following statement:

First, I would like to commend the staff for the highly technical analysis of the estimated costs and burden sharing approaches of the HIPC Initiative. The analysis will serve as the basic foundation for the sustainable sourcing of finance for this important facility to help the good track record, low-income countries find an eternal exit from heavy debt burdens.

As pointed out in the staff paper, it has come up with the new estimated aggregate cost for assistance under the initiative of $7.4 billion in 1996 present value terms, somewhat lower than the April 1997 figure. This is thanks to general and country-specific assumptions in a comprehensive manner and on the basis of the most recent country-specific debt sustainability analysis. It is important that pending the fully publicized contributions to this initiative, more accurate and realistic estimates of the costs are required to make our aims more feasible.

In regard to the burden sharing approach, it is found that the modified residual approach is more flexible than the multilateral residual approach. It almost reconciles with the views of Paris Club creditors, as reflected in the staff paper and in the latest note from the Chairman of the Paris Club. More efforts are therefore called for to negotiate with the Paris Club to accept our modified residual approach.

Mr. Palei made the following statement:

I have read with interest the paper on updated cost estimates prepared by the staff. Once again we see the very large degree of uncertainty surrounding the HIPC Initiative. Uncertainty is inherent in the debt situation in countries eligible for the HIPC Initiative; in the DSA analyses; in the burden sharing mechanism; and in the coverage of debt for rescheduling by the Paris Club.

There are several issues related to the treatment of the debt of the HIPC countries to Russia. Of course, these issues can be addressed only as a part of a more general process of Russia becoming a member of the Paris Club. To complete this process, individual country discounts have to be finalized. In addition, bilateral debt reconciliation between Russia and other countries is required. The success and timing of the latter depends not only on Russia and the Paris Club, but on the cooperation of many debtors as well. Therefore, I ask the Directors to convey to their authorities the importance of the reconciliation of the débts to Russia and to use their influence to ensure full cooperation of the authorities in this matter.

In current situation, the working assumptions used by the staff with respect to Russia seem reasonable.

Mr. Disanayaka made the following statement:

With regard to burden sharing, we also are led by two basic considerations: the preferred creditor status of the Fund and country-specific considerations, rather than the burden sharing mechanics in extending assistance.

In respect of the preferred creditor status, our views are more on Mr. Taylor's definition rather than on the flexible definition of Mr. Yoshimura. It is well recognized that the Fund and the multilaterals have a preferred creditor status in the market, in the world, and in financial circles. There is a great degree of moral hazard attached to this if we ever deviate from our traditional definition of preferred creditor status. So, we prefer that we stick to the traditional notion of preferred creditor status for the Fund in dealing with this HIPC Initiative and the Fund's involvement.

So, considering the various pros and cons of this matter, the difficulties in coming to any certain conclusions, and the degree of controversy that is prevailing which we hope will be resolved very soon, our major preference is for the modified residual approach. As a compromise, we would prefer the fully proportional approach if it gives a consensus and if later the Paris Club shows there is some opening. We hope that we should be able to resolve it a little faster than normal speed.

One word about the financing. Our chair is more worried about this aspect, because we are already on the threshold of getting into several other countries and we are still struggling to find the financing for this Initiative, which was acclaimed as one of the most dynamic instruments that the Fund developed in the recent past. But we are still struggling, trying to carry a baby here. I thought that particularly our friends from the developed world, the donor countries, would make every possible effort to resolve this financing gap. Otherwise, all what we talk about here would be of no use if ultimately we do not have something to distribute. So, I am very worried about this aspect of the matter.

Also, I am worried about the certain amount of laxity we have shown in applying the eligibility criteria over the last few months. Prudence, as Mr. Guzmán-Calafell says, should be the rule in this area. We do not have adequate funds. The Fund is also not very certain. We are going to embark into an area where a lot of commitments are involved, but funding is very scanty. It has an effect on our credibility as a multilateral institution.

Mr. Iradian made the following statement:

We prefer the modified residual approach and, as a compromise, we would accept the fully proportional approach.

On the new target of net present value of debt to exports, I wonder whether it would be more appropriate to consider only those HIPC cases with relatively high debt to GDP ratios, say 50 percent or 60 percent.

Mr. O'Brien made the following statement:

We would like to support the call with regard to the costing for more information. The assumptions are so sensitive and the basis for the cost estimations are so imprecise that we think that some indications of the magnitude of swings would be useful in terms of having a better idea of the range in which the costs are likely to vary. Certainly, we would support the call by Mr. Newman for more information with regard to the countries themselves and to the creditors.

With regard to the assumptions as well, the question of the net present value export ratios, one wonders how realistic these may—given the performances indicated in our present review under the ESAF/HIPC arrangements and the slippages, perhaps the targets we are aiming at are too ambitious and should be reduced. Perhaps the review that is being currently undertaken would give us a better idea as to what kind of programs one would need to institute in support of the ongoing debt reduction initiatives to enable the member countries to achieve debt sustainability.

With regard to the burden sharing, we would have preferred the modified residual, but clearly the position of the Paris Club does not seem to make that feasible. So, we would support the proportional approach, which seems to have a much better chance of success.

Also, with regard to the preferred creditor status, clearly there is a difference of opinion as to what this really constitutes. Our chair would be more inclined to support a flexible view of this. But perhaps it would be useful for the Board if the major principle of the preferred creditor status could be reiterated for the benefit of members, so that while we look at the range within which that principle may be applied, we could have some idea of what we are discussing and whether any particular initiative will preserve that principle.

The Director of the Policy Development and Review Department made the following statement:

Staff and management share the concerns about the status of the funding of the initiative. So far, we have succeeded in obtaining the authority to transfer as much as SDR 180 million from the Reserve Account of the ESAF Trust for the purpose of financing the HIPC Initiative. However, looking forward to the cases where a decision in principle has been taken, as in the case of Uganda, or cases that are expected to be brought forward in the near future, such as Mozambique and Guyana, the aggregate cost to the Fund for those countries could exceed SDR 180 million. That means that sometime between now and the end of the year the Fund will be confronted with the financing issue.

The cost estimates are conservative on purpose, because at this point the staff does not have indications of the Board's views on such issues as targets, length of the second period, etcetera, in individual cases.

Consequently, the estimates should be viewed as indicators of the cost envelope.

The letter last September from the Chairman of the Paris Club to the Chairman of the Interim and Development Committees should not be viewed as the sole reference of understanding between the Paris Club, the Fund and the Bank on burden sharing. The situation evolved, and subsequent Board discussions brought forth interpretations of the implications of the Paris Club agreement for the parallelism of action by the multilaterals and the bilaterals, etcetera. The staff has continued to receive indications from Paris Club creditors as to what may or may not be feasible under the principles established in that letter.

The same applies to the question of preferred creditor status, which is and has been a very difficult issue for the Board. While no formal interpretation or definition of preferred creditor status exists, there is a need, however, to interpret preferred creditor status in the context of this Initiative. The initial, very strict position taken by management is that all other creditors should forgive all claims on the countries before the Fund would act. However, the first proposal by management was for the bilateral creditors to reduce the net present value of their claims on countries by 90 percent. That was motivated, to a certain extent, by another principle—the need to establish sensible, pragmatic, credible creditor and debtor relationships, and this has been a principle upon which the Paris Club itself and other creditors have insisted in those operations. Paris Club creditors responded by indicating their readiness to reduce their claims by up to 80 percent in NPV terms on a case-by-case basis under a proportional approach.

In its response, management signaled that it would not accept disproportionate action by the Fund and by the other multilateral institutions. Furthermore, the proportionality ought to be assessed by what other creditors did after the full application of the initiatives then on the table, i.e. Naples terms. Management indicated that if there were a risk of disproportionate action by the multilaterals, discussions with the Paris Club would need to be reopened.

The Bank went further than Fund in defining preferred creditor status—it was to be based on proportionality. The Bank would not contemplate going beyond, in a proportional fashion, the relief provided by the bilateral creditors—the Paris Club and other bilateral creditors together.

The proportional approach outlined in the paper is not meant as a proposal by the staff or management; it has been included as one of the possible alternatives. It does have certain features which have now been confirmed in the statement from the Paris Club, importantly that the base of any calculation of proportionality would be Naples terms. It does imply acceptance of simultaneous action by the multilaterals and the bilaterals up to 80 percent. While the Paris Club statement leaves open the possibility of the multilaterals doing proportionately more—because it does not explain the basis of additional action beyond 80 percent by the Paris Club—it is clear that the

Board's guidance to staff is not to accede to such disproportionate burden sharing.

The staff may need to consider further Mr. Newman's request for the country-specific data. All of the data used in these calculations has not been subject to full reconciliation, and the staff was not in all cases certain that all of the claims of all the creditors have been fully incorporated. In a number of cases, DSAs have not been endorsed by the authorities. It is unclear whether the staff could provide the specific data without a prior formal agreement with the other creditors involved. There might also be a risk of creating a sense of entitlement, once the calculations were made known. Uganda may serve as an example. Several years ago Uganda's figures would have shown a result much higher than the situation required after the advances made by Uganda in the last few years.

Regarding the question about whether or not the interest from SCA-2 could accrue, we have explored the question in depth and concluded that it was not feasible. The SCA-2 rests in the GRA. In a sense, it does accrue interest by providing interest-free resources to the GRA, and it generates saving in the GRA. However, no legal way exists to transfer the savings—the implicit interest income—on the SDR 1 billion worth of resources from the GRA into the HIPC Trust Fund.

Ms. van Geest inquired whether additional steps could be taken, including a decision by the Board, that would make it possible for the SCA-2 balances to accrue interest. That would increase the amount of the refunds to the members, and indirectly the amount that they could contribute to the initiative. However, that might not be possible under the present rules.

Mr. Kiekens said that the Board had the power, with the needed majority, to change the SCA-2 instrument so that, beyond SDR 1 billion, the interest should accrue to the SCA-2, and not to the GRA.

The Deputy General Counsel made the following statement:

The SCA-2 resources are a line item within the GRA, and for legal purposes are treated as part of the GRA. Executive Directors will recall some concentrated effort in terms of the conduit that could be followed to extract these resources as a contribution to ESAF-HIPC that took place in the Board about a year and a half ago, when these elements were discussed at length. In short, as long as these resources remain in the GRA, they cannot be used to recoup interest for the purposes of the HIPC Initiative.

Mr. Kiekens remarked that the proposal was not to divert interest from the GRA to the HIPC Trust Fund. The decision would only be that the interest accrued by the assets of the SCA-2 reserve account would remain in the SCA-2 reserve account.

The Deputy General Counsel replied that those resources were in the GRA and, as such, could not be treated as a separate account in the sense that interest could be identified and applied to another purpose.

The SCA-2 decision could be amended or terminated by a special majority, and in that circumstance presumably it would require the judgment of the Board that the purpose of the account had been met or that other contingencies could be taken to avert the risk related to the rights accumulation program. While such course of action could be taken, under the decision itself there was a vested right of members to have returned to them contributions that they had made through the increase of charges or the change in remuneration. So, in that situation, the assets could not be freely disposed of by the Fund through a decision of the Board.

Ms. van Geest noted that the expectation was that the SCA-2 balances would be refunded to members and that they would then have the opportunity to contribute those funds to the HIPC Initiative. As the SCA-2 accumulated no interest, the net present value of the commitments was being eroded. Would it be possible, within the existing legal scope, to ensure that the value of the SCA-2 increased? It might be useful to explore the issue.

The Deputy General Counsel replied that the staff had examined the issue the preceding year and no solution had been found. The constraints in the Fund's system of accounts, and particularly the resulting protection of the resources in the GRA and the way in which the Fund was funded, were very severe indeed. The matter was further complicated by the latent rights of members to the SCA-2 resources after its termination.

The staff representative from the Policy Development and Review Department said that the reason the costs to the Fund had risen less than the costs to other multilaterals in the staff's calculations was because the total costs included a variety of countries, each with a different group of creditors. Consequently, a change in the figures for a particular country could have a disproportionate impact on different creditors—in this case, the cost for countries on which the Fund had large claims had risen much less than for other countries, or indeed in some cases had fallen.

Mr. Newman inquired as to how the staff would measure effort in assessing burden sharing in cases where either creditors or institutions were providing interim relief between the decision and completion points.

The staff representative from the Policy Development and Review Department indicated that such effort—including that of Paris Club creditors that provided flow reschedulings above Naples terms—would be allowed for in the calculation of burden sharing.

The Acting Chairman made the following concluding remarks:

> Executive Directors welcomed the updated cost estimates for the HIPC Initiative provided in the paper, noting that total costs for all creditors were now estimated to be around \$7½ billion, lower by approximately \$1 billion than the preliminary estimates made in April 1997, but still substantially above the June 1996 estimate of \$5½ billion. In discussing costs, speakers pointed to the importance of assuring the robust sustainability for all eligible HIPCs while also containing costs. The need to interpret the current cost estimates with caution was recognized by many Directors in light of the data limitations and the sensitivities of the estimates to the assumptions made regarding general aspects of the initiative as well as in the context of country-specific debt sustainability analyses. Several Directors emphasized that projections should

not prejudge decisions on eligibility, on NPV ratios, or on the length of periods between decision and completion points in individual cases.

Directors expressed different views on burden sharing under the HIPC Initiative. A number of Directors continued to endorse the modified residual approach. However, many Directors favored the fully proportional burden-sharing approach, considering that it represented a reasonable compromise which would protect the multilateral creditors' need for risk sharing at higher cost levels and the bilateral creditors' concern that they not proceed first or alone in providing HIPC assistance. Several of those Directors expressed support for the approach communicated yesterday by the Chairman of the Paris Club, and considered that it would provide a reasonable basis to move ahead with all but the most exceptional cases, which would need to be considered on a case-by-case basis.

Many Directors expressed concern that a continuing lack of agreement on burden sharing could impair the ability of the international community to proceed smoothly in the implementation of the initiative. In this light, there was a broad welcoming of the Paris Club statement and support for a fully proportional approach. We will need, of course, to hear from the Bank, including at its Board meeting tomorrow, and from other multilateral creditors. But, subject to this important caveat, I sense a broad view that, so long as the Paris Club statement could in practice result in full proportionality, this might be a way we could proceed. We will bring this issue back to the Board when we know about the views of the Bank and other multilateral creditors.

A number of Directors noted that the cost estimates presented for the Fund were substantially higher than presented earlier, and raised questions about the Fund's financing of its participation in the initiative. The staff will prepare a further paper on this subject for discussion after the Annual Meetings, when we will be in a better position to report on any further developments in our efforts to secure bilateral contributions.

Several Directors requested that country-by-country estimates of costs be provided. I have asked the staff to examine this question with Bank staff, possibly in the context of country-specific debt sustainability analyses, and taking account of the need to avoid creating a sense of entitlement or diverting attention from broader issues. We will have to get back to the Board on this question.

Mr. Taylor said that the reinterpretation of the concept of preferred creditor status would be useful and he supported Mr. O'Brien's suggestion to reiterate the principles of preferred creditor status in a staff paper.

The Deputy General Counsel made the following statement:

In recent years, this Board has discussed the preferred creditor status of the Fund on several occasions. It has been pointed out that the preferred creditor status has evolved in practice, and that it serves to protect the Fund in terms of the fulfillment of financial obligations toward the Fund by members.

The essence of the preferred creditor status is that the membership of the Fund itself is prepared to defer to the preferred creditor status, and to reinforce the repayments to the Fund.

It would be possible—and this was explored by the Board in 1989 and 1991—to attempt to codify the preferred creditor status in more formal and explicit legal terms. But, upon the weighing of the pros and cons of that idea, it was agreed that the unwritten constitution was, for this occasion at least, the best one.

Let me now turn to the question of the application of the preferred creditor status of the Fund in the ESAF-HIPC Initiative and the negotiations related thereto. As Mr. Boorman stated, the preferred creditor status concept has been injected to some extent into those discussions, into the equation of the financing, and the relative economic consequences of contributions, on the one hand, and of the value of debt rescheduling and refinancing, on the other. The Legal Department has found no discomfort in that invocation; there is nothing in the use of this concept that would conflict with the traditional concept of preferred creditor status of the Fund.

Mr. Taylor remarked that it was important to have a common understanding and agreement within the Board on the concept of preferred creditor status.

Mr. O'Brien stated that he was not seeking to have a codified definition of preferred creditor status enshrined in the Articles. There was nothing wrong with an unwritten constitution, provided that there was a clear, common understanding of what that constitution was. In that context, the divergence of views on the issue during the course of the Board discussion was a source of concern. A closer understanding was needed among Board members with regard to the interpretation of the concept. That would assist the Board in its deliberations by allowing it to judge how individual proposals respect the concept of the preferred creditor status.

The Acting Chairman stated that the points made by Messrs. Taylor and O'Brien were well taken. The Board was dealing with one of the rare cases that revealed some slight difference of opinion on precisely how the preferred creditor status concept translated into practice in a particular case. While it was doubtful that the Board's discussion of the issue could make much headway in this case, the Board should revisit the issue if it ever became necessary.

2. BULGARIA—1997 ARTICLE IV CONSULTATION; AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1997 Article IV consultation with Bulgaria and the first review under the 14-month Stand-By Arrangement for Bulgaria approved on April 11, 1997 (EBS/97/124, 7/2/97; and Sup. 1, 7/22/97). They also had before them the authorities' letter of intent (EBS/97/122, 7/2/97), as well as a statistical appendix (SM/97/181, 7/10/97).

The staff representative from the European I Department stated that the issue of the energy subsidies to the district heating company had been successfully resolved. Also, the preceding day the EBRD had signed an agreement with the authorities concluding the privatization of the first bank in Bulgaria, the United Bulgarian Bank. Those two actions had put the World Bank in a position to move forward with the financil and enterprise sector adjustment loan (FESAL).

Mr. Wijnholds made the following statement:

When the Bulgarian authorities started their comprehensive and ambitious program for macroeconomic stabilization and structural reforms in April this year, they faced a critical economic situation. The history of generally loose financial policies, weak enforcement of budget constraints, and slow progress on transformation of the economy from state ownership and central planning to one based on market principles brought about serious deterioration of the economic conditions. The staff report is quite frank and lucid in describing the depth and harshness of the crisis that ravaged the Bulgarian economy in late 1996 and early 1997. The severe foreign exchange and banking sector crisis were followed by a sharp decline in economic activity and growing budgetary difficulties, and serious loss of credibility and confidence in economic policies and financial institutions. I believe it is not necessary to go over the grave consequences for the Bulgarian population, companies and banks, as well as to repeat what is already known about the causes of the crisis. It is more important to underline that the severity of the crisis made the Bulgarian population at large better understand the lack of genuine reform, and opened a new window of opportunity for radical reform.

The economic adjustment and structural reform policies consistent with the financial framework based on a currency board arrangement have produced remarkable results so far. Firstly, as regards the formal performance criteria and prior actions, the program is generally on track. All performance criteria at end-May were met, while the implementation of the prior actions for conclusion of the first review was fulfilled and preparation of the World Bank's financial and enterprise adjustment loan is nearing completion.

Secondly, the program produced striking stabilization results. The faster than expected restoration of confidence in the national currency and financial institutions, as well as the more appreciated level of the exchange rate brought about more favorable inflation and interest rates performance. Indeed, monthly inflation declined from almost 250 percent in February to 5.6 percent in May and 0.8 percent in June. Concurrently, the Bulgarian National Bank reported on Thursday, July 17 its latest decline in interest rates continuing a series of rate reductions that began in early April and brought the basic annual interest rate to 6.1 percent from almost 630 percent just four months ago. Equally noteworthy is the sizable increase in lev deposits, which only in the first two weeks of the introduction of the currency board arrangement grew by more than 25 percent. Last, but not least, the official foreign exchange reserves, excluding gold, increased from just over \$500 million at end-March to \$1,344 at end-June, and further by another \$170 million (DEM 300 million) by mid-July.

Understandably, the prospects for output and export recovery have been revised downwards mainly reflecting carryover effects, but the weaker economy and lower imports would account for higher current and trade accounts surplus in 1997. As far as fiscal performance in concerned, the budget outcome for the period March–May was in line with program assumptions, and while the revised macroeconomic framework yielded a budget for 1997 with a primary surplus of 4.1 percent and an overall deficit of 6.3 percent of GDP, the fiscal stance remains consistent with the explicit rules of the new monetary arrangement.

Bulgaria's economic and structural reform program is based on the explicit rules of the currency board arrangement (CBA), as well as on restrictive fiscal and incomes policies, and an extensive array of structural reforms.

The new monetary regime, namely the currency board arrangement, was the logical choice to signal a break with the past. Indeed, after several unsuccessful money-based stabilization attempts, the Bulgarian authorities decided to implement a rule-based regime instituted on an legislative commitment to exchange domestic currency for foreign currency. It was generally expected that the new regime would restore confidence in the national currency and banking system, bring rapid disinflation and facilitate macroeconomic stabilization. The initial results, as noted earlier, are quite encouraging. Concerning the issues of the institutionalization of the CBA and the structure and balance sheets of the central bank, I believe the staff report describes them well. I would only like to touch briefly upon two issues, namely on the debate over which currency and at what level the lev should be pegged, and on the safety margin added to this otherwise rigid regime. First, the debate over which currency the lev should be pegged to has enjoyed enormous attention from the media, policy makers and public at large. The analysis on the pros and cons of each of the two most obvious choices, namely the German mark or the U.S. dollar, was based on the need to assure viability and sustainability of the new monetary regime, and to lead to the achievement of its objectives. As far as both currencies were expected to yield similar benefits, the authorities opted for a forward-looking approach and pegged the lev to the German mark. This decision is not very surprising as far as Bulgaria's trade flows are predominantly with European countries. In addition, a peg to the German mark would eventually lead to a peg to the future European currency, the Euro, which on its side will significantly facilitate Bulgaria's efforts of joining the European monetary union in the future. As regards the level at which to peg the exchange rate, the Bulgarian authorities were of the opinion that fixing the lev at a more depreciated level than the prevailing market rate at that time would trigger inflation and renewed pressure to raise wages. Having in mind the need to consolidate the gains on inflation, the authorities decided to peg the lev close to the prevailing market rate at the end of June, namely at a rate of 1,000 per German mark. Second, having in mind the build-in rigidities of a pure CBA, and particularly the elimination of traditional central bank functions, the Bulgarian authorities favored introducing a safety valve in the monetary framework, in the form of limited lender-of-last-resort operations (LLR). The Bulgarian authorities felt that this margin would add to the sustainability of the new regime in the long term and enhance its credibility through limiting the risks of systemic liquidity crisis. In order to preserve the CBA's credibility, however, the new arrangement provides that only foreign exchange reserves in excess of the currency backing could be employed for LLR support or other monetary operations.

Given the significant constraints imposed by the CBA on domestic financial policies, prudent fiscal and incomes policies are crucial for its viability as well as for preserving competitiveness of the economy. The authorities' strategy for the 1997 budget remains as envisaged under the initial program. More precisely, the budget will not rely on credit from the central bank, consistent with the requirements of the CBA, and will limit the increase of internal and external debt to ensure medium-term fiscal sustainability. Admittedly, when looking at the main parameters of the 1997 fiscal program, it seems that fiscal targets are not sufficiently ambitious. I would respond that this whole budget is about realism, and it clearly reflects the very weak economic performance in the first months of this year. More important, however, the revised macroeconomic framework provides the basis for achieving lower inflation despite the larger overall deficit as far as the entire deficit is expected to be financed through privatization receipts and official foreign financing. Needles to say, the Bulgarian authorities remain keen to improve the fiscal position through strengthening tax revenues and controlling noninterest expenditures. Improved tax administration is in the center of the authorities' revenue-enhancing measures. In this regard, they have in the last month inter alia established a large taxpayer's unit, which covers the largest tax payers in the country, strengthened administration of the value-added tax, and undertaken a more aggressive stance toward collecting tax arrears. Concerning noninterest expenditures, the authorities intend to keep them broadly unchanged in percent of GDP through tight control of expenditure allocations for the pension fund, wage bill, and subsidies to selected industries. These measures should contribute to a successful achievement of the fiscal deficit target for 1997, clearing the way for an almost balanced budget of the central government in 1998. Final decisions for the next years fiscal stance will be taken in the fall, and it is expected that the new budget will envisage further reform of the tax system and rationalization of expenditures.

An appropriate incomes policy is also vital as far as its successful implementation will assist in reconciling the objectives of consolidating the gains on inflation and preserving external competitiveness. To this end, the slippages that had occurred in March–May, have already been addressed by making incomes policy legally binding. In the period ahead, incomes policy will be guided by the principle that wages should evolve in line with the financial performance of enterprises and a wage bill ceiling will be set in reference to projected inflation.

Finally, on structural reform issues, the Bulgarian authorities have made important progress in the process of restructuring and transformation of the economy. Privatization continues to be the mainstay of the program, supported by liquidation and financial isolation of the unviable state-owned enterprises, restructuring of the banking sector, agricultural reform and further trade liberalization. The accelerated privatization has already generated total proceeds of over US$250 million, most of it over the past months, while international agents were appointed to complete the privatization of several large enterprises. At the same time, the liquidation of the largest loss-making SOEs contributed to the elimination of over 28 percent of the losses in the industrial sector. The process of restructuring and transformation of the state ownership will continue under the new FESAL-supported program.

The Bulgarian banking system is today basically sound, after having overcome a crisis of confidence resulting in closure of 18 state and private banks that accounted for 32 percent of total deposits. An accelerated restructuring of the banking sector produced a reallocation of banks' portfolios from credit to highly liquid assets, and by early in the second quarter all remaining banks except one were solvent. More recently, the position of the remaining weak state bank was supported through recapitalization in agreement with Fund and Bank staff, while another one is being privatized with the participation of the European Bank for Reconstruction and Development. The privatization of the remaining state banks remains a high priority of the government, while in the meantime the amended Law on Banks will improve bank governance and strengthen bank regulations.

The authorities have also strengthened their efforts to improve business environment and attract foreign investors through speeding up agricultural sector reform, liberalizing further trade and exchange regime, improving transparency of public policies and initiating a bold campaign against crime and corruption.

Although the initial results are encouraging, and investors have responded favorably to the authorities' efforts, much remains to be done. The commitment of the authorities to pursue economic policies consistent with the requirements of the new monetary regime and the strong package of prior actions give strong assurances that the present program will continue to be successfully implemented. With a view to accelerating and deepening structural reforms in order to provide the foundation for sustainable growth and rising living standards, the Bulgarian authorities have requested the assistance of the Fund in developing a coherent medium-term program that could be supported by an Extended Arrangement. The discussions on a new program are expected to begin in the context of the preparation of the 1998 budget.

Mr. Kaeser made the following statement:

After the terrible crisis Bulgaria recently went through, and the many uncertainties which surrounded the future in the aftermath of that crisis, the excellent results which the staff has reported to us today are truly heartening. We would like to congratulate the new authorities of Bulgaria for their commitment to reform, and express our satisfaction with the staff for the hard work and the vision they have brought to the challenges of one of the most difficult situations arising in the region this year. As all performance criteria for end-May were met, most with substantial margins, and given that the conditions for completing the first review have been fulfilled, we support the proposed decision of the staff to consider the review completed.

Monetary policy has been very carefully designed in Bulgaria, and has already succeeded in eliminating hyperinflation. The only immediate difficulties with fiscal policies are those caused by the unexpected magnitude of the success in fighting inflation. Therefore, we will limit our comments in the area of macroeconomic policy to some aspects of the structure of fiscal expenditures. Our other comments concern structural issues, and here, as well, we will be brief since substantial progress has been made across the full range of policy commitments under the Stand-By Arrangement and the World Bank FESAL. We would like to comment on incomes policy, the worsening unemployment situation, the on-going losses of the state-owned enterprises, and banking sector issues.

We note that subsidies are still being provided to the district heating companies, selected coal mines, and the electricity company (for investment). We would encourage the authorities to require these companies to raise prices in order to recover their costs fully. This would take some pressure off the budget, reduce inefficiencies, and promote energy conservation.

Unfortunately, the need to reduce noninterest expenditures has led the authorities to cut spending on maintenance and operations to a significant extent. This area is of particular importance in the long-run perspective, and should not be sacrificed to short-term considerations. On the other hand, we wonder if there might have been room for cutting more in the area of nonproductive military expenditures.

Lastly, a 10 percent reduction in employment is planned, also to reduce expenditures. We wonder if it will be possible to carry out restructuring on that scale in such a short time, while maintaining the quality of the public services. Also, this would add considerably to the numbers of the unemployed, which would also require new expenditures to cover the greater needs of the unemployment fund. Our guess is that the potential for savings in this area may be somewhat overestimated.

The second issue we would like to address concerns the measures being taken in the case of enterprises that are found to be exceeding the wage bill ceilings. Managers will be required to lower wages or to make staff redundant in order to comply with the ceilings. We would like to point out that the two options will not have identical effects on the budget. Lay-offs will lead to increased pressure on the unemployment fund, while lower wages will simply create the desirable effect that the most mobile employees will have an incentive to look for jobs in the more profitable sectors which can offer better pay. This point, as well as the one we brought up concerning the 10 percent reduction in employment, would seem to indicate that the consequences of growing unemployment for the budget may not have been adequately taken into account.

A related issue concerns the seriousness of the unemployment situation, which is at about 14 percent, a relatively high figure for the region. In addition, in the Statistical Appendix, we note that in the preliminary data for 1996, less than half of the registered unemployed were receiving unemployment benefits. This would appear to indicate a considerable hole in the social safety net, and we hope that progress has been made since then or is being made to patch it up.

Turning to the problem of the state-owned enterprises, the amount of losses still being made by these enterprises is disturbing. According to the Letter of Intent, the liquidation of SOEs which are not viable has contributed to eliminating in excess of 20 percent of the loss of the sector. That means that the lion's share of the losses are still being perpetuated. We encourage the authorities to move forward in the privatization or liquidation of loss-making enterprises as quickly as possible.

Concerning banking sector issues, we note that the schedule for the introduction of international standards to assess capital adequacy is stretched out over the next two years; and the goal for end-1997 is modest: while minimum capital adequacy of 12 percent is the international norm, and the goal for 1999, Bulgarian banks will only be required to reach 6 percent by the end of this year. Therefore, risks remain high and this points to the important role which will need to be played by the strengthened supervisory framework. As our remarks imply, the twin dragons threatening stabilization—the loss-making enterprises and the weaknesses in the banking system—have not yet been totally mastered. We are confident, however, that, after the terrible crisis of last spring, the new team of policy-makers and the social partners are fully aware of the necessity that reforms in these areas go forward as planned.

Mr. Kiekens and Mr. Jonáš submitted the following statement:

It is too bad that Bulgaria had to fall all the way to the bottom before it could accept the failure of its "neither plan nor market" system and muster sufficient political support for a genuine market reform. Now that the currency board arrangement is in place, there is a chance that Bulgaria's hopeless stop-and-go stabilization efforts can be replaced by a comprehensive package of stabilization and deep structural reforms capable of durably improving the country's economic performance.

No one should imagine that the Currency Board Arrangement provides an alternative to real reform. On the contrary, its purpose is to give the reform more credibility. And not even the strongest political commitment to deal with all of the economy's malfunctions will produce substantial improvements anytime soon. The task ahead is daunting, with zero room for complacency and slippages. Progress in stabilizing the currency and bringing down inflation and interest rates has been faster than expected, but this must not be twisted into an excuse to relax the reform effort. The staff report makes it quite clear that Bulgaria's stability is extremely fragile and beset by risks from many directions. The principal risks are connected with the high level of external debt, and the situation of the fiscal and banking sectors.

The faster than expected reduction of inflation brings its own problems. A part of budgetary spending is determined in nominal terms, which means that a failure of inflation to behave as originally expected could cause large swings in real spending. When inflation is lower than predicted, sticking to nominal spending targets not only results in higher real spending, but also causes the budget balance to deteriorate because real revenues do not increase as fast as real spending. During periods when the inflation outlook is uncertain, budget commitments defined in nominal terms can turn out to be quite expensive. We wonder if there is any way to alleviate this problem, whether by shortening the period to which spending commitments apply, or by adjusting the spending, in the next period, to offset any excess of real spending in this period. Without such an adjustment, we fear Bulgaria's budgetary situation will remain extremely fragile.

This fragility has already shown up in the higher than originally projected budget deficit for 1997, and in a higher than programmed actual budget deficit for March–May 1997. And although the staff is sure that the projected overall budget deficit of 6.3 percent of GDP is consistent with the CBA, it is worrisome that it leaves little or no room for maneuver in case of adverse shocks.

The higher than programmed March–May deficit is explained by the authorities' decision to overfund the budget and by lower value-added tax revenues. But we do not fully understand why the overall balance for the whole year is now expected to be much further out of line than the present March–May balance. According to Bulgaria's March Letter of Intent, the overall balance for the whole 1997 was expected to be better than the March–May balance, improving from the March–May deficit of 5.1 percent to a whole-year deficit of 4.1 percent. Now the overall balance for 1997 is expected be a deficit 6.3 percent of GDP, which would be a 0.7 percent of GDP worsening from the March–May period. The overall fiscal balance for 1997 is a significant 2.2 percent worse than the earlier projection.

The increase in the deficit is due inter alia to a projected shortfall in revenues over the whole year. Revenue collections seems to be a problem. Even though actual revenues in March–May were higher, for the whole year they are expected to be lower than called for in the March Letter of Intent. We are not sure whether the lower than expected inflation can explain all of this difference. Tax revenues are expected to weaken during the year, from 23.8 percent of GDP in the March–May period to 23.4 for the whole year. In contrast, the March Letter of Intent projected a significant strengthening of tax revenues during the year, from 21.8 of GDP in March–May to 25.1 percent of GDP for the whole year. There seem to be some problems with tax collection.

One reason for the weaker revenue performance is the raising of the threshold and tax brackets for personal incomes, which will reduce the revenues expected from the personal income tax by 1.5 percent of GDP. In addition, the presently inadequate arrangements for taxing the private sector could hamper revenue collection once privatization goes forward. Given the weaker overall and primary balances, the high demand for public spending, and the importance of keeping current in their servicing of the external debt, the authorities should proceed carefully to avoid hampering revenue collection while taking measures that work in the opposite direction, including a more aggressive approach to tax arrears.

Another reason for the accommodation under the program of an increased fiscal deficit is that interest payments are now expected to be 1.4 percent of GDP higher than initially assumed. We would like to insist that if interest charges in the second half of the year should turn out to be lower than is now projected, the government would be restrained from increasing noninterest expenditures. Any unavoidable spending increase should be financed through fiscal contingency reserves.

Another serious problem that could affect the budget is the situation in the banking sector. The mishandling of the banking sector's problems in 1995 and 1996 could still have very costly effects. At that time, despite negative net worth and large portfolio shares of nonperforming loans, the banks were allowed to remain open and were made to provide credit on the basis of political criteria. This combination of politically-motivated lending and the financial weakness of the banks' clientele may in the end result in high costs for cleaning and strengthening the banks. The staff mentions that there is a contingency budget reserve of 1 percent of GDP to meet the potential costs of bank and enterprise restructuring. But we suspect that the total costs of cleaning up the mess in the banking sector could be much higher. In light of plans to privatize the banks soon, we would expect a more complete picture of their financial situation to be available. We would be grateful for any additional information about the probable costs of cleaning out the banks' portfolios, and about the sharing of these costs. And of course we strongly endorse the authorities' plan to privatize all banks soon to reputable foreign investors, to enforce market discipline on bankers, and to strengthen the credibility of supervision.

For the banking sector reformation to succeed, a similarly aggressive approach must be taken to the structural reformation and privatization of the enterprise sector. By the end of 1996, only about 6 percent of the fixed assets of state owned enterprises had been privatized, which speaks for itself. Given the potential high demand for budgetary resources, and the tight constraints that will be imposed by the CBA, cash privatization should be the rule. It appears that the authorities are taking privatization seriously this time, and we commend them for what they have achieved so far in 1997. After ending the serious lapses, asset stripping, corruption, and other unsavory practices which are liable to discredit reform, we urge the authorities to move decisively to increase the transparency of public policy and of the legal and regulatory framework.

We support the completion of the review and wish the authorities success.

Mr. Vernikov made the following statement:

I am impressed by Bulgaria's economic performance over the last three months. The credibility and quality of the authorities' economic policies have improved dramatically. Overall, stabilization is taking hold in Bulgaria. The authorities are addressing the challenges of the structural reform. The staff's role in putting together a strong anti-crisis package for Bulgaria has been instrumental and deserves the highest praise.

After Bulgaria has introduced the currency board, there is not much to say about the monetary and exchange rate policy. Let me only note that, according to my information, in the weeks preceding July 1, the National Bank has been basically buying foreign currency in the attempt to resist a nominal appreciation of the leva. For some reason, the magic figure of 1,000 leva per DM had been identified as a perfect reference point. I would like to reiterate my argument expressed at the time of the adoption of the Fund arrangement. There was room for leva appreciation without damage to the economy, and only to the benefit of macro stabilization. The overshooting of the present exchange rate is unnecessarily excessive, and Bulgaria will be paying the price for it in the period ahead.

On the fiscal front, the commendable fiscal efforts of the authorities have continued, although, even before the most recent crisis, Bulgaria had an amazingly strong primary fiscal position. Most importantly, however, the adoption of the currency board and the rest of the policy package has contributed to a substantial reduction in the interest rates. As a matter of fact, this consideration has played a crucial role in the decision in favor of the CBA. Now we can see with great satisfaction that the trick has worked. The authorities have received additional breathing space in terms of lower level of debt servicing (in domestic currency). These gains must be consolidated by prudent spending and borrowing policies, especially in view of possible revenue shortfalls under sharply decreasing output in 1997 (-7 percent of GDP) and the extremely heavy burden of external debt servicing.

To follow up on the external position, a theoretical viewpoint suggests that a depreciation of the leva must enhance exports. That may, however, take some time, while in the immediate future the closure of inefficient enterprises, including those generating exports, might narrow the export base and increase pressures on the trade balance. As on previous occasions, I was somewhat intrigued by the staff's optimism: Table 5 (p.37) suggests that 1997 exports will grow after a drop in the previous year. Hopefully, exports from newly emerging private companies will pick up and offset its shortfall from traditional sources. Competitiveness of Bulgarian exports is not a major issue at the moment. However, developments in consumer price index-based and unit-labor-cost-based real exchange rate must be monitored closely. It is known that there is a very fragile edge beyond which a fixed exchange rate may start doing more harm than good to the external sector. Incomes policy should also be brought to the center of attention in the course of subsequent reviews of the Bulgarian program.

Absence of effective structural reforms has predetermined the failure of previous stabilization programs and Fund arrangements. Nowadays the Bulgarian authorities have demonstrated their full and sincere commitment to push forward with structural transformation. The ambitious privatization plans in the enterprise and banking sectors are impressive indeed. In this regard, I think that the quality of ownership transformation and the amount of privatization revenues should not necessarily be sacrificed to the speed of public assets' sell-off. After all, it is an effective private sector, not just unreformed nonpublic sector, that will pull the Bulgarian economy out of depression. In addition, much needs to be done to create a stimulating business environment in terms of judicial and legal systems, liberalization of administrative and price regulations, and enforcement of arms-length policy in economic decision-making. The last crisis had, to a considerable degree, been triggered by unlawful actions by company managers (e.g. asset stripping of SOEs) and by fraudulent practices in the financial sector. Public divestiture and even privatization cannot do all the job if business practices remain broadly the same as before.

In conclusion, I agree with the staff that, on balance, the strength of policies has been preserved and the risks of the program have been contained. It enables us to complete the review. The program is clearly on track, and the recent completion of the pending structural measures once again proves that. I support the proposed decisions and wish the Bulgarian authorities every success in their bold efforts.

Mr. Esdar made the following statement:

We can go along with the thrust of the staff's analysis and recommendations and support the proposed decision. I would like to be brief today since we have had a comprehensive discussion on the economic situation in Bulgaria just three months ago.

It is encouraging and commendable that the new government without any hesitation has endorsed and committed itself to the program which was agreed before. The assessment of Bulgaria's situation by market participants seems to have been brightened significantly since the adoption of the Stand-By Arrangement and the subsequent strong adjustment efforts of the authorities, not at least reflected by reduced interest rates and favored by a significant reduction of inflation beyond earlier expectations.

Thus developments so far support the view that our decision to go ahead with the Stand-By Arrangement before the election of the new government seemed to be justified and our trust in the new government has not been disappointed.

However, we are just at the beginning of the consolidation process and significant risks are still ahead. We, therefore, welcome the strong commitments by the authorities to continue to implement the rigorous adjustment path agreed with the staff.

Overall it is crucial to stick steadfastly to the reform agenda and especially to maintain strict fiscal discipline and to undertake the necessary structural reforms without delay. In this respect the reform of the tax system and the tax administration are of similar importance as a sustainable cut of expenditures which includes the reduction in the number of public employees and a more ambitious phasing out of subsidies. The information provided by Mr. Wijnholds is very encouraging in this respect (p. 3, para. 2).

Doubts have been raised about the timely completion of several privatization projects, which will have significant impacts on the budget. Perhaps the staff could comment on the likelihood of delays here and their budgetary consequences and also on the question whether the intended privatization of only 50 percent of the utilities seems sufficient.

The restructuring and reform of the banking system also has to play a crucial role in the adjustment process not at least to facilitate policies under the currency board arrangement. The staff has mentioned that comprehensive technical assistance from various sources is currently provided in this area. Maybe the staff could comment to what extent such technical assistance is adequately coordinated. The staff's comments are also appreciated on the current situation of the insolvent banks which have been mentioned on page 25 in the footnote, of which only four have been closed.

We have discussed the pros and cons of the currency board arrangement at earlier occasions. However, I have to take up this issue again since we are somewhat concerned about the information in the staff paper (para. 24, page 18) that the authorities have "underscored their commitment to the permanency of the CBA" and announced "that only EMU would lead to a change in the peg." We agree that it is important to explain the functioning of a currency board arrangement to the public and that it is sometimes necessary to do this in a very simplistic way. However, we believe that it could be very risky to generate the expectation of or even to give a political commitment for lasting exchange rate stability. On the one hand we have a lot of evidence—and some quite recently—that exchange rate commitments can create severe imbalances in the financial system if the actors are misguided to neglect the exchange rate risk. We also have the experience that market forces frequently enforce exchange rate adjustments based on the perception of changes in fundamentals. Therefore, the authorities should maintain the option to exit from the external anchor without unduly complicating such adjustments by political commitments. Indeed it is important to acknowledge the transitory nature of the CBA to the public.

We have noted that the authorities have shown interest in an early switch to an Extended Arrangement. We have sympathy and are encouraged that the authorities like to put their adjustment efforts in the context of a medium term Fund supported adjustment program. However, given the relatively short period under the current Stand-By Arrangement and the mixed experience under earlier arrangements we would encourage the authorities to consider an EFF-arrangement only if a convincing track record under the Stand-By Arrangement is established. An early switch might also irritate markets. A convincing and sustained track record could prepare the grounds for an ambitious follow-up Extended Arrangement. In this context we would like the staff and Management to take a close look not only on Bulgaria's reform agenda but also on her actual balance of payment need when considering such a program.

Mr. Costa made the following statement:

After a severe political and economic crisis, Bulgaria has managed to regroup the forces willing to pursue tough macroeconomic and structural reforms while fighting crime and corruption. Although the political will is unquestionable, as testified by the overwhelming victory of the pro-reform party, and the economic program is sound and comprehensive, as proven by the agreements reached with this institution and the World Bank, risks remain high and the margin for errors is very small. Paradoxically, the main risk may not reside in the fiscal area with a deficit projected to reach 6.2 percent of GDP in 1997, nor in the 566 percent level of inflation, nor even in the 15 percent level of unemployment, but rather, as indicated in the statement by Mr. Kiekens and Mr. Jonáš, in the complacency that may take hold with the renewed confidence that the stabilization program will produce.

The authorities will have heed past experiences that to achieve a lasting success, a steadfast commitment to macroeconomic discipline and to structural reform is required. The fact that on this occasion a currency board arrangement underpins the program imposes additional caution. Most likely the favorable reaction of markets will be stronger than in the past and the authorities would be well advised not to conclude that there is no need to speed up structural reforms. This risk is compounded by the increased access to private international capital markets brought about by stabilization, which may undermine fiscal discipline. We could safely assert, therefore, that the existence of a program with the Fund and its strict compliance is a critical requirement to reap full benefits of credibility from the new institutional framework and we would welcome the authorities' request for continued assistance by the Fund under an Extended Arrangement when the present Stand-By Arrangement program runs its course.

Particularly important for the sustainability of the economic program is the soundness of the banking system which has the crucial task of intermediating financial resources to the most productive uses. An abundance of liquidity resulting in rapid credit growth increases the risk of unwise credit decisions. In these circumstances it would be advisable not to delay reforms aimed at strengthening bank supervision, prudential regulations, and to consider setting legal reserve requirements at a relatively high level until firmer prudential standards are in place. We would appreciate knowing whether the authorities envisage any prudential role for legal reserve requirements. With respect to minimum capital requirements the goal of achieving a 12 percent level within two years seems appropriate. However, what is more important is the banks' attitude in handling risk which in turn is linked to how they perceive their chances to be bailed out in case of trouble. The existence ex-ante of a fund within the Banking Department of the Bulgarian central bank to cope with liquidity crisis with systemic implications, covering 15 percent of broad money, may serve to reassure the financial system as a whole, but it contains the risk of creating moral hazard particularly at this early stage of the restructuring process both in the banking and the public enterprise sectors. It is therefore imperative that there be a clear understanding by all participants on the strict conditions that should be met for access to supplemental liquidity. Another important consideration in this regard is the nature of the deposit insurance mechanism that is being contemplated which could have a deleterious impact on the budget if not designed properly. We would appreciate the staff's comments on the envisaged extent of the coverage and its financing.

Fiscal performance is being affected by the change in the nominal framework which has rendered a higher projected deficit for 1997 than initially planned. There seem to be no doubt, however, that the 6.3 percent of GDP overall deficit will be financed without resorting to monetization by the central bank. Moreover, budget projections regarding privatization receipts and domestic interest payments seem conservative and present considerable scope for savings particularly if inflation declines more rapidly than projected. On the other hand, as in many other transition economies, there are institutional and cultural constraints for raising revenue quickly. The authorities should be encouraged, and provided with necessary technical assistance, to strengthen the tax system particularly to encompass the largely untaxed private sector and to reduce exemptions. Regarding public expenditure we wonder if cuts in subsidies to public enterprises and a more important reduction in defense expenditures, as mentioned also in Mr. Kaeser's statement, could not be contemplated to accommodate expenditure on basic infrastructure and human capital development including a workable safety net. Finally, given the high level of indebtedness, we agree with the staff's view that fiscal sustainability largely depends on a steady decline in the public debt to GDP ratio.

Having chosen a CBA as the cornerstone of their economic program, the authorities will need to consider complementary measures to achieve consistency and in particular to preserve competitiveness since the use of exchange rate adjustments has been relinquished. I believe this quest for consistency should be the foremost goal of the authorities rather than spending time in considering alternative exchange rate regimes as suggested by Mr. Esdar. In the first place, incomes policy will have to be carefully designed to contain nominal increases of wages, except for those strictly justified by productivity gains. Although it is noted in the paper and in the letter of intent that wage bill ceilings will be set with reference to projected inflation, this nevertheless institute an indexation of wages which runs contrary to the fixity of nominal variables. Staff comments would be welcome.

A second consideràtion relates to the openness of the external sector and the importance of liberalization of both current and capital account transactions, in particular those related with foreign direct investment. This is the surest way to preserve competitiveness through productivity gains brought about by the introduction of modern technology and managerial expertise, while at the same time effectively checking the rise of tradable goods' prices. On the other hand, if there is progress in strengthening the banking supervision framework, the liberalization of capital movements will more quickly bring money markets rates to international levels, reducing the overall interest rate level of the economy. We welcome, therefore, the relatively liberal trade and payments system of Bulgaria and its commitment to further liberalization.

Moreover, in order to ensure market discipline at the micro level, it is essential that the commitment to privatize all commercial SOEs and half of the utilities not be delayed. As Mr. Esdar we wonder, however, why half of the utilities will be exempt from privatization. Proceeding with the privatization of all public enterprises, including public owned banks, is deemed to be the most straightforward means to increase efficiency and fight crime and corruption, particularly taking into account the fact that in Bulgaria those institutions were recently the vehicle used by criminal elements to squander public resources.

In addition, we consider it important to pay more attention to accelerating reforms which improve the incentive structure in the agricultural sector so as to avoid the situation whereby a traditional grain exporter as Bulgaria has to rely on imports on a regular basis. In this regard, the process of restitution of property rights on agricultural land deserves priority.

Finally, unemployment, at a rate of 15 percent, is already a serious problem particularly when the economy has yet to absorb the impact that will result from the projected structural reforms. It goes without saying that an effective and well-targeted social safety net is essential. At the same time, however, efforts to relocate expenditure toward education and training of displaced workers, that could take the form of subsidies to private companies for in-job training, should be given high priority. We believe that the authorities should from the outset pay special attention to the unemployment problem to avoid a weakening of the social and political support of the reform program.

Mr. Iradian made the following statement:

The staff has produced a clear, well-balanced analysis and a pragmatic approach to the complexities of economic stabilization and reforms in Bulgaria. The background section in the staff report was particularly useful in clearly pointing to the root cause of the country's problems, namely the slow pace of structural reforms. The main conclusion of this section, which is worth repeating, is that strong stabilization efforts in the absence of coherent and comprehensive structural reforms will most likely not succeed and even destabilize the macro economy.

As detailed in the staff report, Bulgaria appears to be entering a new phase in economic management. We are encouraged that all indicative and performance criteria for end-May 1997 were met, in some cases with substantial margins. Both inflation and interest rates were lower than programmed, confidence in the lev returned quickly, and the introduction of the currency board arrangement proceeded in the context of a comprehensive policy package of macroeconomic and structural reforms, including major restructuring in the banking and enterprise sectors. We find these developments extremely encouraging. I broadly share the staff's analysis and recommendations, and support the completion of the review. In what follows, I will highlight certain areas for emphasis.

With the establishment of the CBA, the program provides a concrete basis for a break with the past and appears to have strong public support. These are important attributes that must be underpinned by the necessary supporting financial policies to maintain credibility in the new arrangement. Of equal importance, as the lessons of the past clearly show, is that the full benefits of the reform will only materialize when key structural reforms are maintained and strengthened. Here we underscore the banking sector and the public economic sector.

With respect to the fiscal framework for 1997, like the staff, we would have also preferred a tighter fiscal stance for the remainder of this year. However, we share the view that the budget, in addition to being consistent with the demands of the CBA, should be realistic, both economically and socially. Additional meaningful expenditure cuts may prove to be difficult and counterproductive, and may cause an excessive compression of domestic demand. In this connection, we share Mr. Kaeser's concerns about the impact of further cuts in productive spending. The extent of the fiscal adjustment and particularly expenditure cuts should not be underestimated. Current noninterest expenditures, which stood at 37 percent of GDP in 1993, are projected to decline to 21 percent this year. At this level, they would be the lowest among the Central and Eastern European economies. On the revenue side, there is limited scope in the short term to increase taxes, given the need to strengthen incentives in the economy. Given the recent sharp decline in interest rates, beyond the staff's projections, the domestic interest payments should decline. This would enhance the prospects of achieving the fiscal target for 1997. Staff comments would be appreciated. Nevertheless, we encourage the authorities to intensify efforts to strengthen revenues through improved tax administration and firmer resolution of tax compliance to ensure that noninterest expenditures are kept in line with revenue performance. In this connection, we are encouraged by the authorities' commitment to take corrective action should attaining the 1997 target be endangered.

Clearly, the success of the program will depend, to a large degree, on determined efforts at addressing areas in structural reforms. In this regard, we welcome the marked progress made in the banking sector, as noted in Mr. Wijnholds's helpful statement. These should be continued. In particular, the full implementation of the strengthened supervisory framework through the use of the extensive technical assistance provided by the EU and the Fund should be pursued vigorously. Private ownership and management of commercial banks, and entry of reputable foreign banks should be encouraged to foster competition and import prudent banking practices.

With regard to public enterprises, we are pleased to note that cash privatization had accelerated and that proceeds in excess of program targets will be used to reduce public debt further. It is important that the government continues to liquidate or close loss-making enterprises.

Finally, looking ahead, the sequencing of the structural measures should be timed so as to coincide with a strengthening of social protection programs. Improved social indicators would contribute to the social and political acceptability of the reform effort. This aspect highlights the importance of revenue-enhancing measures in order to finance the necessary social expenditure programs. With these remarks, we support the proposed decisions and wish the authorities every success in the pursuit of their reform objectives.

Mr. Andersen made the following statement:

I welcome recent impressive improvements in Bulgaria's economic performance, and support the proposed decision. The Bulgarian authorities are faced with an opportunity to take the economy forward by means of renewed commitment to the transition process. In light of widespread support by the public and the international community, the window of opportunity appears to be wide open, indeed.

So far, the policy agenda is appealing. The policy framework, with emphasis on the currency board arrangement, is likely to anchor the economy much tighter than its predecessor, the money-based approach. However, a currency board is not a panacea that can prevail without appropriate policy support. As noted by Mr. Kiekens and Mr. Jonáš in their statement, the task ahead is indeed daunting, with no room for complacency or slippages. And as we move forward with this latest economic experiment in Bulgaria, the staff is right to identify structural reform as the true test of its durability.

More generally, I somewhat fear that there may be a risk of fading social consent as the experiment goes on if the public does not see the benefits of tighter financial policies in their pocketbooks for quite some time. Thus, while the window of opportunity is still wide open, drawing on our experience with other transition countries, it is of the utmost importance to advise the authorities to front-load necessary structural reforms in order to pave the way for a more efficient economy. Experience has taught us that early action on the structural side pays off by reducing the painful side effects of transition. Let me add just three brief comments on the policy content.

I can approve the thrust of the fiscal policy measures, albeit with some hesitation for reasons already stated in several of the statements. I find the bottom line of 6.3 percent fiscal deficit this year somewhat short of deserving the title "ambitious," and perhaps also short of supporting the currency board arrangement. The authorities may not have the luxury of presenting consecutive which are labeled realistic but economically and socially, because confidence lost on the fiscal side will hurt confidence-building on the monetary side. Clearly, there is a synergy between the framework and the content of policy to the extent that financial markets might not be willing to buy into an economy where the picture does not fit the frame, while they may be willing to pay a premium for a harmonious fit. Thus, I would find it advisable that the authorities take yet another look at the expenditure items in the budget while front-loading measures to enhance the revenue side.

Incomes policy plays an important role in the early stage of stabilization, as it has in previous stabilization experiments in Bulgaria. I can appreciate the authorities' desire to keep the lid on wage developments in state-owned enterprises, but I wonder if this is done at the price of efficiency, especially in the somewhat longer run. On balance, the economic literature has given incomes policy some credit for squeezing inflation in the short run. I think that may also hold true in this case. But I fear the life of some unprofitable enterprises could be unduly prolonged if rigid incomes policy measures are sustained, although I take note of the principle that wages should evolve in line with the financial performance of enterprises. Maybe the staff could elaborate a little further on whether they see the now-legally binding incomes policy as sufficiently flexible, and at the same time likely to be sufficiently effective.

Finally, in the area of structural reform, the emphasis is rightly tilted toward privatization, particularly in the industrial sector that it is still dominated by state enterprises. While I note that the authorities also intend to limit remaining distortions in the domestic economy, I find this plan rather short in details on how to outlaw the practice of rent-seeking behavior and corruption, which has complicated, if not plagued, the functioning of market mechanisms in the past. I am not convinced the problem will disappear just because an enterprise changes hands, in which case efficiency gains from privatization would continue to be undermined. I wonder if the staff could elaborate further on what is being done to address corruption directly or indirectly.

Mr. Watal made the following statement:

Our chair is happy to note the renewed confidence of the Bulgarian authorities and the already evident results of the strong stabilization and reform measures that are in the process of being implemented under the umbrella of the Fund program. The staff also feels that "the strength of the policies being implemented continues to be preserved and the risks to the program are contained." Both these assertions are important because we have seen on earlier occasions temporary successes in Bulgaria being wiped out by spells of financial indiscipline.

It is understandable that Bulgaria's vicissitudes have largely been caused by an economic legacy burdened by very high external debt and economic relations with her neighbors which manifested relatively greater distortions in the market system. The restructuring processes have therefor been more difficult to actualize for the Bulgarian authorities. But now with the United Democratic Forces in absolute majority we can look forward to a period where inflation will continue to be controlled and the burden of reforms distributed equitably. The decision of the authorities to introduce the Currency Board Arrangement from the 1st of July was a bold step and no doubt enhanced the all round market confidence. We hope the authorities will treat this policy as a vehicle to enforce financial discipline and improve the performance of public economic institutions. We are in broad agreement with the thrust of the staff appraisal and also the measures being implemented in the program. Mr Wijnholds's helpful statement has also given an up date on what is happening in Bulgaria.

In a scenario where Bulgaria had to see the steepest ever rise in prices since 1991 with a sharp fall in personal consumption, the need for rapid stabilization and a commitment to deep structural reform was without doubt of utmost relevance. The authorities are to be congratulated for meeting the June quantitative targets and the prior actions which facilitated the Currency Board Arrangement. The immediate effect of this arrangement is more than satisfactory. But to continue to reap the fruits of the arrangement and to minimize the concomitant risks, the package has to be supported by strong fiscal policies, vigilant banking supervision and privatization of enterprises and banks at the same time addressing important social needs like supporting real pensions and wages. The authorities and the Fund staff have worked in tandem to incorporate the necessary requirements and milestones to monitor the program and make the arrangement effective.

There are reasons to believe that exchange rate anchors are better in controlling inflation in transition economies as compared to the control of money supply which requires more sophisticated banking mechanisms than the establishment of an exchange rate peg. Exchange rate stabilization may be preferable whenever the underlying commitment of the policy makers to fiscal discipline is high and this seems to be the case now in Bulgaria. Because of the implied hard currency backing of the DM and the shielding of monetary policy from credit demands we feel that the CBA in Bulgaria has a high probability of success and a lower cost of disinflation. The fixity of the peg could give rise to extreme rigidity in the context of a need for supplying short term contingency liquidity to the banking system. The staff and the authorities have worked out an arrangement that would provide an element of flexibility in an extreme emergency situation. In this context the health of the banking sector would be crucial to success of the CBA. The steps being taken to enhance the privatization process would import good banking practices into the system. Strengthening of the supervision processes. We welcome the new Banking Law that has laid the foundation for better bank governance.

The current measures would go a long way in controlling inflation and facilitate growth after the stabilization gains have been achieved. We agree with the reasons for accepting the DM as a nominal anchor in view of the goal of integrating with the EU. But what is the rationale of the statement that this will be a permanent arrangement till Bulgaria enters the EU?

The steps taken by the authorities to tighten incomes policy in the second quarter of 1997 and make it legally binding seems to have broad social support. This will facilitatė equal sharing of the burden of reforms. As pointed out by the staff this would also maintain the cost competitiveness. But we would also strongly re-emphasize the associated risks that need to be guarded against. The programmed fiscal adjustment, though the staff feels is within the requirements of the CBA, does manifest worrisome features and we hope it does not go out of line especially with the basic objective of not using central credit. The authorities decision therefore to avoid revenue losses by postponing asset revaluation through the review of the tax system in preparation of the 1998 budget with the FAD is welcome. Given the uncertainties concerning revenues, the other tough measures on the tax side are equally welcome and the requirement to limit commitments of spending agencies to 90 percent of the allocated funds to improve expenditure control is also a good strategy. Even credit needs of the nongovernment sector leaves scope for stronger than programmed remonetization. This would have to be watched through very close and effective bank supervision.

The external debt ratio at 97.5 percent of the GDP and debt service at 10.8 percent of GDP in 1997 makes this an important and risky factor. Debt management is again linked with proper fiscal management and proper implementation of the incomes policy. The staff has mentioned that there will be a financing gap of $93 million in 1998 which would be taken care by the consultative group meeting at the year end and also improved access to international capital markets and FDI flows. Still in our view this aspect must be monitored closely. We also join the staff in encouraging the authorities to normalize relations with bilateral creditors.

Finally, we would also like to add a word of caution. While extreme measures have been taken to put the Bulgarian economy on rails, it should not be forgotten that this will have associated social costs. The authorities must take steps to prevent the measures that can have serious consequences on the vulnerable sections of society in terms of aggravated deprivation.

In conclusion, we congratulate the staff for providing well written and clear documents and we support their recommendation for the completion of the review. We also commend the authorities for the bold decisions they have taken and wish them success in their future endeavors.

Mrs. Paris made the following statement:

The current arrangement with Bulgaria has started off well, and I am pleased to support the proposed decision. Indeed, we are today in a position to complete the review under a Fund arrangement with Bulgaria—an unknown situation for three years. I therefore commend both the staff for its intense work and the authorities for their resolve to adhere to the program, and I strongly urge them to persevere in that direction since the situation is still fragile, and ongoing efforts need to be sustained and intensified to ensure lasting success on the path to recovery and the transition process.

As I endorse most of the staff recommendations, I will limit my statement to a few specific comments or questions. First, on fiscal policy. In their last report, the staff pointed to the possible need to reassess the fiscal target should the reduction in inflation differ from what was expected. This was presented essentially as a simple adjustment in nominal terms. In light of the difficulties encountered, I wonder if, as suggested by Mr. Kiekens, a self-correcting system could be put in place to ensure avoiding any deviation in real spending in the future.

Furthermore, the staff emphasized the urgent need for tax reform and improvement in tax administration so as to strengthen the fiscal situation. I cannot but strongly support these recommendations. As such measures are not likely to raise revenue quickly, however, I wonder whether there would be some scope for exceptional revenue measures to be implemented next year so as to allow further room for maneuver.

Second, I note that interest rates have fallen much faster than anticipated—much faster, in particular, than in Estonia or Lithuania after the introduction of their currency boards. Since interest rates appear now to be negative in real terms, I would like to know what staff expectations are for the rest of the year. More broadly, while it is certainly useful to keep in mind the strong potential for remonetization of the Bulgarian economy, such a rapid restoration of confidence should be looked at carefully.

The liquidity position of banks gives them greater scope for credit expansion, although the early stages of restructuring in the enterprise sector makes lending activities still rather risky. This points to the need to strengthen the supervisory framework, but also raises the question of when lending activities would actually resume in Bulgaria, and, in the meantime, how the reflow of bank resources can be fruitfully used. I wonder whether the staff could provide their views on this.

As for fixing the exchange rate, I concur that the adopted level, which has the merit of being a round number with the deutsche mark, is a reasonable compromise between the need to restrain inflation and the need to maintain export competitiveness. The choice of the nominal anchor exemplifies the forward-looking approach of Bulgaria and its aim to strengthen its European ties, which is welcome. Yet, as it appears that domestic banks would have, as a result, an open exposure to the U.S. dollar, the need to hedge their position should be taken into account promptly. I wonder whether the staff could comment on the actions currently envisaged in this regard.

Lastly, like previous speakers, I would like to stress the need to continue ongoing progress in structural reforms. The program of privatization and restructuring, which should benefit from the support of the World Bank through the FESAL, should, in particular, be vigorously implemented.

Mr. Melese-d'Hospital made the following statement:

I would like to thank the staff for an enlightening set of papers, particularly as regards the operation of the new currency board arrangement (CBA) and reform of the banking sector. The authorities have achieved much in a short period of time. The strength of this ambitious program of stabilization and reforms can be seen in the early favorable response from markets (even prior to implementation of the CBA), with inflation and interest rates falling much faster than expected. If fully and quickly implemented, the program should bring significant tangible benefits to the vast majority of Bulgarians. As I am in broad agreement with the staff's views and recommendations, I will focus my comments on a few key areas which I feel deserve emphasis.

Against a background of complete loss of credibility and in the context of the new CBA, Bulgaria's program depends on the absolute commitment of the authorities to maintaining a tight fiscal stance and keeping their hands off the levers of credit. In addition, the program requires deep structural reform and extensive privatization; indeed, it envisions the substantial removal of the state from the economy. To succeed with this truly ambitious agenda, the authorities will have to exhibit ownership of every aspect of the program. Happily, this appears to be the case today, but the authorities may nonetheless face tremendous pressures to relax policies and backtrack on reforms in the future. Let me be unequivocal in stating that, with Bulgaria's poor track record of policy implementation, markets can be expected to be unforgiving of any disappointments.

As I am sure is clear to all of us, the risks to the program are substantial, and deviations from program assumptions will almost certainly have important effects on outcomes. Yet the staff paper offers only a light treatment of proposed responses to changes in key variables (responses to poor revenue outturns are treated on page 23, paragraph 37). I would be particularly interested in hearing the staff's views on potential risks to the banking system under the CBA stemming from volatility in interest rates and capital flows, and whether the recent pressures on various emerging markets' currencies have had any effect.

I understand from discussions with the staff that, while domestic interest rates were programmed to decline steadily through the rest of the year to hit 2.5 percent/month at end-1997, in reality rates are already below 1 percent/month, and that, if maintained, such rates would reduce the deficit by 1-1.5 percent of GNP in 1997 and lead to near budget balance in 1998. This development holds extraordinary promise for the success of the program, but also carries the risk of untimely relaxation of fiscal policy and of postponement of politically painful structural reforms. In this light I would like to ask the staff's view on the authorities' level of commitment to maintaining programmed fiscal policies and structural reforms even when the most obvious argument in favor of such policies (the unsustainably high deficit) is diminished.

A key factor in assessing the sustainability of Bulgaria's external position is the volume of capital inflows; with external debt near 100 percent of GDP and debt service at 16.3 percent of goods and nonfactor services, even small changes may have major repercussions down the line. I note in the staff paper (page 28, paragraph 48) that the staff estimates foreign direct investment of $430 million for all of 1997, "some" return of flight capital, and BOP support sufficient to generate a BOP surplus of $800 million; this would permit gross official reserves (excluding gold) to reach $1.6 billion by end-1997. A recent report indicated that the BNB's foreign currency holdings on July 11 had already exceeded this amount. I would like to ask the staff for an update on the status of inflows, and for clarification on the return of flight capital.

Notable progress has been made by the authorities in just a few months in reforming the banking sector, for which they should be commended. Strengthening the banking sector has taken on enormous added importance under the new CBA, and close cooperation with the World Bank under the FESAL and proposed FESAL II and with EU, USAID and Fund technical assistance will be crucial in this effort. In this light, I note in the staff paper (page 25, footnote 20) that of the 15 banks put under insolvency proceedings in 1996, only four court decisions for liquidation have been confirmed so far. Liquidation of failed institutions will be key to building confidence in the banking system and in the asset values behind state banks to be privatized. Could the staff comment on this delay?

The authorities should be under no illusion (and it appears that they are not) that problems of excessive credit creation are solved simply because a currency board is in place. It will be vitally important to the success of the CBA and indeed the entire program that other sources of credit and quasi-credit (including government guarantees) be effectively contained. At the same time, I would like to weigh in on the side of the staff in the debate outlined in the staff paper (page 25, paragraph 41) on the importance of adequately funding the "lender of last resort" function of the banking department of the BNB. Recognizing the many competing claims on the Bulgarian budget, I would suggest to the authorities that they consider augmenting these resources in the future out of proceeds of additional privatizations beyond those currently planned.

Mr. Grilli made the following statement:

The program in Bulgaria has been very successful so far and has been probably more successful than was expected by the staff and by us. This is a pleasant surprise, which, nonetheless, raises the risk of overconfidence, a risk that has played negatively in Bulgaria in the past and has contributed to the reversal of previously achieved gains and to negative results. We therefore think that the very positive results achieved so far should constitute a stimulus for the Bulgarian authorities to go forward and avoid becoming complacent.

There are two areas in which we think attention should be focused. One is the area of external debt that has reached almost 98 percent of GDP and debt service almost 10 percent of GDP, which constitutes a factor of vulnerability to shifts in external confidence. External confidence the authorities will need for many years to come simply to roll over the existing stock of debt. The presence of such a large stock of debt and debt service burdens highlights the importance of Bulgaria not relying further on debt-creating capital flows but rely, instead, on nondebt-creating capital flows. Access to markets should be maximized on the second type of instrument and not on the first.

External confidence will also be necessary to compress the interest burden, given the size of the interest payments and given the sensitivity of interest rates to capital flows in a currency board situation. In order to have a reasonable debt service burden, capital will have to keep flowing, and at reasonable costs. This underscores again the need for maintaining confidence, which depends on reform efforts and achievements.

The second area on which we think that attention should be focused is the reform of the tax apparatus. Here, reform of the system is urgently needed both in terms of its clarity, its certainty, and of the rules that apply. It is necessary, given the confidence-building process; but it is necessary in order to stem also the continuous fall in tax revenue in relation to GDP, which has been really remarkable and continues.

The recent over-adjustment of thresholds in personal income tax brackets by the government which, in effect, resulted in tax relief is an indication that in this area a new system needs to be put in place and a lot of attention needs to be placed on the functioning of the tax. Bulgaria also has a large informal economy which needs to be brought back into the open and, therefore, reform of the tax system will have to pay due attention to designing appropriate incentives for that to happen.

Let me make a passing reference to a problem with bilateral creditors that Bulgaria has; it is a problem which in itself should have already been solved but which, in effect, is holding up the rescheduling in the Paris Club. There is an issue with German banks and then an issue with Italian banks that can be and should be easily solved. I hope that the staff continues to impress upon the Bulgarians the advisability of solving these problems. On our side, we are very flexible in understanding the situation, but simply we cannot accept the fact that the same loans are going to two state-owned banks, one of which is recognized as a public guarantee and the other of which is not. Let me urge also the Bulgarian authorities to attempt a bona fide solution on that issue.

I have a question for the staff. I wonder how the recent trend in exchange markets has influenced the Bulgarian economy, and if they could elaborate on what a currency parity change would imply for the currency board.

Mr. Shields made the following statement:

This chair took a critical view when the Stand-By Arrangement came to the Board in April, not so much because of the program, but because we were not confident that in the run-up to the elections we were actually in a position to make a sensible judgment about Bulgaria's ability to meet its obligations. As it turns out, it has generally done remarkably well so far, and I, for one, am delighted that our fears did not materialize.

Of course, we are still in the preliminary stages; there are lots of uncertainties ahead. There are many areas where the authorities need to concentrate harder to ensure that this program will be successful. They need to guard against complacency after the history of Bulgaria in the last few years. The staff appraisal, in Paragraph 56, makes some very relevant comments about what needs to be done and for the authorities not to allow themselves to rest on their laurels. They clearly have been having a honeymoon period, particularly with the financial markets, but that could certainly come to an abrupt end if observers sense that there has been any slackening of the momentum of the reform effort, or we see the old insider interests starting to affect decisions too much in Bulgaria, or indeed if there are serious exogenous shocks. So, the paper was right to be generally cautious in its forward look.

On the sort of crucial elements of the program, others have commented on the revenue and expenditure outlook. It does look as if the revenue targets are optimistic, as many of us thought at the beginning of the program, although for rather different reasons than they have turned out to be. It is important that there be some bumping up of revenue collection. It is more important to make progress on this side. There are limits to what can be done really on expenditure compression, given the enormous needs. There may be some help through interest rates, but that is not that secure. The most important thing clearly, given the currency board arrangement, is for the overall deficits to be held down.

On the effects of success, there have been various questions raised about possible future strains on the banking system, partly due to how it is adjusting to inflows. Perhaps, it is also relevant to think of how well is it going to adjust to this new climate of low inflation and low interest rates. I wonder if the staff has anything to say on whether the banks are actually properly prepared for the sorts of new risks and the sort of spreads that they ought to be presenting at the moment.

A key issue for the medium term is the relationship between banks and enterprises to make sure that resources are efficiently allocated. There has been good progress in making sure that the authorities now have the instruments so that proper financial discipline can be imposed. But they do need to demonstrate that these instruments will be fully used. We have already heard comments about relatively low rates of bankruptcy that actually have been imposed. It is very important that this become an entrenched part of the system, and not just when there is external pressure from the Fund or the Bank.

Like Mr. Andersen, I would like to hear a little bit more about the fight against crime and corruption in Bulgaria. The staff report talks about it being prominent in the policy platform. I am wondering about actions on the fight against crime and corruption.

I support this review, and I wish the authorities every success in their new course.

The staff representative from the European I Department said that the banking system was much stronger than a year earlier. Seventeen banks had been closed, and ten of them had since been either privatized or liquidated. The remaining state banks were all solvent, with adequate capital, and were expected to be privatized. In fact, the privatization of the United Bulgarian Bank had been finalized the preceding day. Another bank would be put up for sale in August, and two other banks in September. The weak bank, Biochim Bank, had been recapitalized, and the government was seeking a privatization or management contract for that bank. The remaining state bank, the Bulbank, was considered to be the strongest bank in Bulgaria.

As a result of the consolidation, the banking system should be able to withstand pressures, the staff representative continued. The banks were highly liquid after shifting their portfolios into government paper, and most of them had excess reserves of two or three times required reserves. The strengthening of banking supervision should help prevent excess credit expansion. Thus far, commercial banks had been hesitant to expand credit, but the situation would need to be kept under close review. Changes in reserve requirements could be considered, should problems emerge.

The banks had the ability to hedge their dollar exposure within the prudential regulations, the staff representative said. However, at the moment, most of the banks held long dollar positions because they had a high portfolio of the recapitalization ZUNK bonds, which were dollar denominated, and it would take them some time to rebalance their portfolios.

Turning to the intended coverage of the lender of last resort fund, the staff representative indicated that the size of the banking department was about $300 million. That amount was not intended to be used—a provision subject to tight controls—but to provide confidence to the banking system. The recent reflow of resources into the banking system suggested that the fund was indeed serving its purpose. From March, the capital reflows had totaled about $1 billion—a little over $400 was accounted for by disbursements from the Fund and from privatization receipts, and the other $600 million represented a reflow of private funds into the system, most of it coming from domestic residents. At the beginning of the stabilization, with interest rates very high, foreign money had been flowing in to buy government securities, but with interest rates having declined so dramatically, most of those funds had been redirected to other countries.

The recent relatively rapid interest rate decline had been aided by the diminishing demand for funds from the budget, the staff representative continued. In fact, the government had been reducing the stock of its outstanding debt. That, combined with the aforementioned reflow of capital meant that more money was chasing fewer government securities, which had been driving down interest rates. The trend was likely to be reversed later in the year when banks began to learn how to use some of their resources to make loans, and when seasonal pressures for imports materialized. Consequently, interest rates could move up toward the end of the year.

Negative real interest rates were not unusual in a CBA, the staff representative continued. In fact, Estonia and Argentina—two other countries with CBA regimes—had had negative interest rates for periods of time. It should be noted that the differential between rates of return on the lev and returns on the dollar or the deutsche mark, remained positive.

The delays in budgetary consolidation had been associated with the changes to the personal income tax designed to adjust for the effects of inflation and to provide relief to households whose incomes had fallen dramatically, the staff representative indicated. That had cost 1.5 percent of GDP and had been very difficult to make up as expenditures had already been considerably compressed. A Fiscal Affairs Department mission would be traveling to Bulgaria in September to review the overall tax system and identify measures needed to deal with some of the structural problems—in particular with the issues related to the effects of hyperinflation, such as the revaluation of assets, the taxation of revaluation gains in the banking system, and the implications for budget revenues. In addition, the staff would like to see some rollback of the exemptions given to recently privatized firms.

The staff expected the lower than anticipated interest rates to help achieve the 1997 fiscal target, the staff representative continued. If interest rates remained at 1 percent per month for the rest of the year, the budget would save 1 percent of GDP. Current interest rates were actually lower than that; thus, even greater savings could be realized. The staff agreed with comments made by Directors that the saving should be used to reduce the deficit, not to increase spending. Therefore, the staff had put great emphasis on the achievement of the primary balance in its discussions with the authorities, which they fully supported. They were aware of the need to generate a primary balance in the order of 4–5 percent of GDP in 1998, given the reduced availability of exceptional financing.

The need for a self-correcting mechanism of spending control would likely decline over time, as the big fluctuations in inflation which had caused the problem earlier in the year had now subsided, the staff representative remarked. The authorities had limited spending by agencies to only 90 percent of their allocations, so as to retain a cushion on the expenditure side. That should be sufficient at the present levels of inflation.

Privatization of utilities was not limited to 50 percent, the staff representative indicated. Rather, 50 percent was the privatization goal within the next two years—by the end of 1998 or early 1999. The privatization program was very ambitious, covering all enterprises and banks in the next two years, and half of utilities over the coming two years. Ultimately, the authorities wished to privatize the remaining utilities as well.

Income policy implementation had been one of the areas in which the government had been effective, the staff representative indicated. The policy was designed in a flexible way, with scope to reflect the situation of individual firms. It did not apply to the private sector or to state enterprises that were performing well and profitably and that had no arrears. In contrast, the loss-making companies were not allowed to increase their wages.

Technical assistance coordination had been a problem in the past, and the staff had undertaken much effort to ensure that it would not be a recurring problem, the staff representative said. Much technical assistance was being provided by EU-PHARE and by USAID. In the banking system, the Monetary and Exchange Affairs Department was providing a technical adviser to the banking supervision department. One of his primary functions would be to coordinate the technical assistance provided in the area of banking supervision to help ensure its effective use. A Fiscal Affairs Department technical adviser was also helping to coordinate assistance to the Ministry of Finance on tax administration. After a radical housecleaning inside the Ministry, many department heads, including the head of tax administration, were new and not very experienced, and they had to rely more heavily on outside advice.

The government attack on corruption focused on limiting the opportunities for corruption and the scope for rent seeking by eliminating price controls, getting rid of red tape, and implementing deregulation, the staff representative stated. Opening up the insurance industry to foreign participation was an example of that approach. Bulgaria's insurance industry was notoriously corrupt, and by opening it up to foreign competition, the authorities aimed to initiate a cleanup. The authorities had also prosecuted some bank managers involved in insolvent banks, and requested extradition of those who had fled.

The effects of the recent exchange rate movements had not been significant, the staff representative indicated. The program had been framed around DM 1.7 per US$1. At the moment, the rate was DM 1.8 per US$1, equal to a 6 percent change. The depreciation in fact would tend to help competitiveness, even though it could adversely affect inflation. The staff did not consider that the exchange rate change would have any major effect on the program, provided the lev did not depreciate much further.

The contingency reserve of about 1 percent of GDP, set aside to deal with the remaining problems in the banking system, appeared to be sufficient, the staff representative said. Any future costs would be associated with the government's efforts to clean up banks' assets prior to privatization. However, some of the banks' net worth was positive, and the privatization proceeds from their sale could be used to finance any restructuring of other banks with bad assets. The budget contained a separate allocation for dealing with the bank with negative net worth, Biochim Bank.

Mr. Rodríguez made the following statement:

> First, I would like to commend the staff for a well written set of papers. After two stabilization programs, which proved to be only temporarily successful, the present program based on a currency board arrangement may be lasting because of the commitment to reform of the newly elected government. By endorsing the program adopted by the interim government and vowing to accelerate and deepen structural reforms, the new authorities are providing a new impetus to stabilization. Lower than expected inflation, higher than targeted international reserves and the transfer to the private sector of 600 enterprises, generating $250 million in revenues, point to an auspicious beginning, but the success of the program can only be assessed in the long run.
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> On fiscal policy, I share the same concerns that have already been mentioned by other speakers and for this reason I will not make further comments in this area.
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> As for the deposit of $300 million, that is maintained in the Banking Department of the Bulgarian National Bank in order to provide liquidity to solvent banks in case of systemic risk, Bulgarian authorities believe that a large deposit would send the wrong signal, but I agree with the staff that a rather large sum is convenient. At this point in the program, it is a priority to enhance the credibility on the currency board agreement, safeguarding against systemic risks in the banking system. Well defined and strictly enforced qualifications to be eligible for financial assistance from the Bulgarian National Bank might mitigate possible moral hazard problems.
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> Related to this point, real credit to the nongovernmental sector is projected to increase 17 percent with respect to 1996, backed by a strong recovery of money demand. Apparently, money demand is expected to continue recovering, which could lead to an even higher increase in credit. Even though this may not be inflationary, it may cause other problems. In many

cases, the quality of bank portfolios deteriorates after periods of fast credit growth. Subsequent bank closures have been common, sometimes threatening the stability of the banking system. Maybe the staff could comment on this potential risk, given the current surveillance capacity, and its implications for the currency board arrangement.

The currency board arrangement is enjoying a successful beginning. The parity of the exchange rate with respect to the US dollar has been set 15 percent below the level in the original program, justified in part by the authorities' commitment to adopt a compensating incomes policy. In this respect, the authorities have been consistent. The recent increase in salaries in US dollars has been met with a tightening of the incomes policy in the second quarter. Nevertheless, there may still be some problems ahead: Profitable state owned enterprises, current on all obligations and without outstanding arrears, are free to set wages on the basis of their financial performance. Though this may be an important tool to motivate workers, it is also likely that some enterprises will increase wages beyond productivity gains, while remaining profitable because of other price changes. The concern would be, and the opinion of the staff would be welcomed in this respect, that this could introduce an imitation effect in the wage setting process, affecting the incomes policy and contributing little to an even distribution of the burden of adjustment.

Given the trade balance observed in the past few years, the current level of international reserves and the level at which the exchange rate is being fixed, it is striking that there is still an import surcharge. According to the authorities, it would be eliminated when balance of payments viability is established. Nevertheless, this policy sends a dubious message about the confidence of the government in the program and in the strength of the lev. The authorities are encouraged to reduce this surcharge as soon as possible, and, also, to lift restrictions on the purchases of foreign exchange for tourism and to liberalize capital transactions. In this sense, the acceleration and deepening of structural reforms in the banking and enterprise sectors, the privatization program and the liberalization of trade and prices will foster the sustainability of the stabilization program.

With these remarks, I wish the new Bulgarian authorities every success and I support the proposed decisions.

Mr. Melhem made the following statement:

I welcome the improved economic environment in Bulgaria. The implementation of the adjustment program has yielded most encouraging results. Indeed, the larger than expected decline in interest rates underscores the improved confidence.

This welcome progress notwithstanding, the economy is still fragile and the authorities need to remain fully committed to the program. In this regard, I share the staff's concern regarding the risk of slippages on the revenue side. While lower interest rates provide a cushion, it is essential to monitor the situation closely and implement additional measures if needed. A strong fiscal stance is critical for enhancing confidence and supporting the success of the CBA strategy.

A tight incomes policy is also needed for attaining the authorities' objectives. Indeed, under a CBA, containment of wage increases and inflationary pressures is needed so as not to erode competitiveness. Here, the authorities' efforts to limit wage increases in public enterprises is encouraging. This should be seen, however, as a temporary solution pending privatization and restructuring of these enterprises.

The banking sector is another area that requires continued attention. While progress has been made in strengthening this sector, additional efforts are needed for training of bank managers and employees in prudent lending practices and risk assessment. Enhancing prudential regulations and supervision is also a priority.

With these remarks, I to welcome the progress made in Bulgaria against complacency, support the proposed decisions, and wish the authorities' success.

Ms. Zheng made the following statement:

It is encouraging to read that after a short period of decisive and bold actions, the preliminary benefit of stabilization emerged with most of the performance criteria met. Both the staff and the authorities should be congratulated for the tremendous and complicated endeavors taken to lay the groundwork for these hard-won results. The policy framework, especially the rule-based currency board system, contributed greatly to the restoration of confidence and economic order. With this understanding, I agree with the staff appraisal and Mr. Wijnholds's assessment of the Bulgarian economy, and fully endorse the staff proposal for the completion of the first review under the Stand-By Arrangement. I have selected several policy issues for emphasis.

Fiscal performance seems to be at the heart of the success of the program, given its importance in supporting the currency board system. Although technically it is difficult to accurately project the growth of nominal GDP and inflation in the aftermath of financial crisis, I share Mr. Kiekens's and Mr. Jonáš's concern that expenditure targeting should be adjusted in line with the decline of inflation. Therefore, establishing the mechanism to adjust the budgetary assumption is of crucial importance for further success in fiscal policies. On the revenue side, I also share the staff's concern that raising the PIT threshold without wages increasing in line with inflation could have a negative impact on the revenue. Hopefully, such an impact can soon be offset by strengthened tax administration and expenditure measures as mentioned in Mr. Wijnholds's helpful statement. Staff comments on the overall achievability of the fiscal target for 1997 taking account of the above-mentioned factors could be helpful.

On monetary policy, we view the authorities' implementation of the CBA system as broadly appropriate.

On structural reform, I recognize the significant progress made in transforming the state-owned enterprises through the privatization program, and, according to Mr. Wijnholds's statement 28 percent of losses in the industrial sector have been eliminated through liquidation. However, I would prefer to interpret these achievements with some caution, for the final success of these programs lies in the efficient performance by the transformed enterprises, which we have not yet known. Therefore, it is worthwhile to lay more emphasis on monitoring the post-privatization enterprises and to enhance their efficiency. Because there is no room for error in this important area, the authorities should draw the privatization lessons from the neighboring countries to avoid inefficient privatization. Therefore, Mr. Kiekens's and Mr. Jonáš's suggestion on the merit of cash privatization seems more suited in Bulgaria's case. Could the staff provide information on what privatization techniques are used in Bulgaria— the cash or voucher approach?

On banking sector issues, I welcome the authorities' intention to introduce the international standard for prudential regulation in the next two years, though at present, banking supervision is far below the standard. The risks in the banking sector are still there since the enterprise transformation is only done for a very small part, and there are still some state banks remaining to be transformed. More importantly, banking sector reform should also aim to disconnect the banking decisions from the influence of the government, which has been one of the important causes for the Bulgarian financial crisis.

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

Ms. Cilento made the following statement:

As others have noted, in many ways the performance of the authorities has been exceptional, but realistically it was also what was necessary to underpin the adoption of a currency board against the background of the economic turmoil experienced in Bulgaria over the last year. Perhaps the most pleasing aspect of recent developments has been that the adoption of the currency board has actually produced the outcome hoped for—namely, rapid stabilization. As others have noted, however, while success has come quickly, new-found confidence will no doubt be eroded just as quickly if the authorities show signs of deviating from their commitment to broad-reaching reform. We agree with the staff assessment, so I will just emphasize a few specific points.

I think the adoption of the peg to the deutsche mark at close to market rates is appropriate. However, this has left the authorities with less breathing space. As others have noted, this highlights the importance of maintaining a tight incomes policy. On this front, there were some early slippages. I welcome the authorities' efforts to address these quickly, as noted in Mr. Wijnholds's statement. But it seems likely that over time there will be pressure for real wages to rise. Particularly given the fall in wages last year and the low level of wages, the authorities will need to resist these pressures, which could be difficult. They have introduced what appears to be a strict income policy, but I think an important factor will also be the extent to which they continue to maintain close contact with the relevant social parties, stressing the key role of appropriate real wage moderation.

Privatization is an important aspect of the reform process, but like Mr. Andersen and Mr. Vernikov I think we and the authorities need to accept that this will not be a panacea for the problems that have plagued the Bulgarian economy. I would therefore like to add our voice to Mr. Vernikov's comments that the final objective should be an effective private sector. This will not be achieved if business practices go unchanged. Obviously, important to this will be efforts to fight corruption, improve transparency, and develop a sound legal system. I welcome the staff's comments on these issues earlier on, which give me some reassurance. The comments I had on the fiscal side, mainly relating to revenue collection, have already been addressed, although I might pass on to my own authorities this notion of confiscating cars to make sure that tax revenues are collected. I think that is unique.

Finally, and more seriously, I would like to echo the comments made by Mr. Esdar earlier. I think the Board took a bold step in supporting the program at a time when the political situation was not entirely clear, and against the background of a less than perfect track record. I think the decision was made easier by the efforts of the staff, and particularly its efforts to engage the breadth of political parties in the discussion, which was very useful under the circumstances. I think the Fund's early support has been justified by the performance to date. Against that background, we support the proposed decision and wish the authorities well with their ambitious agenda.

Mr. Mahdavian made the following statement:

At this stage of the discussion, I also would like to submit the full text of my statement for the record. I join other Directors to commend the authorities for their reaffirmed commitment to accelerated economic reform under the current Stand-By Arrangement.

I support the proposed decisions for the completion of the review and wish the authorities success in their endeavors.

The staff representative from the European I Department said that a risk existed that profitable enterprises might raise wages more than was justified by productivity gains, and for that reason the incomes policy was the subject of review under the program. Both the Minister of Labor and the Minister of Industry were very committed to the policy. Both recognized the importance of not allowing the wage growth to undermine industry competitiveness.

Mr. Wijnholds remarked that the authorities' interest in seeking an Extended Arrangement after the completion of the current Stand-By Arrangement attested to their strong commitment to the reforms. It was noteworthy that opposition leaders also supported the approach to monetary reform, recognizing the strong positive effects of the CBA. At this stage, it would not be prudent to emphasize the transitory nature of the arrangement. The

CBA had been introduced as a means of instilling confidence, and it was important to avoid sending the message that it would last only a short period of time. That did not mean that, in the longer run, the authorities should not think about an exit strategy.

While privatization in itself could not guarantee better corporate governance, foreign ownership participation in large industrial enterprises was likely to lead to improvements in that area, Mr. Wijnholds suggested.

Regarding the National Bank of Bulgaria, there had been a complete change in the management, Mr. Wijnholds said. While the new governor, the former Deputy Minister of Finance, was not new to the agenda, there were a number of new deputy governors who, while being competent, did not have much experience. The recent appointment of an eminent adviser to the Bank, a former high official of the Deutsche Bundesbank, represented a welcome development. There was every reason to be optimistic about the prospects for sound functioning of the CBA, and the National Bank of Bulgaria's policies in general.

The Acting Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They observed that, after very costly delays in its transition process, Bulgaria now had an excellent opportunity to reinvigorate and complete the reforms needed to provide the basis for sustained growth and improved living standards. Directors commended the authorities' commitment to reform and were encouraged by their efforts to stabilize the economy, including the implementation of the currency board arrangement. Directors noted that markets had responded favorably to those efforts with stronger than expected declines in interest rates and inflation. Those measures, along with steps taken to improve the soundness of the banking system and the passage of a budget consistent with the demands of a CBA, provided a firm foundation to consolidate the stabilization developments thus far. Directors strongly encouraged the authorities to take full advantage of the confidence in their policies to press forward with their program of broadly based structural reforms. They underscored that there was no room for slippage or complacency, as significant risks remained. Any weakening of resolve could easily erode credibility and confidence and jeopardize macroeconomic stabilization.
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> The swift adoption of the CBA was viewed by Directors as a strong signal of the authorities' commitment to enforce financial discipline. Initial results of the CBA were clearly encouraging, but Directors emphasized that its durability would depend upon the strict adherence to the new Law of the Bulgarian National Bank and would require sustained discipline and vigilance across the full range of economic policies, including the budget, incomes policy, and strengthened performance and governance in the banking and enterprise sectors. Failure to implement effective policies in those areas would eventually be reflected in a loss of competitiveness, rising interest rates, and economic slowdown.
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> Although expressing concern that the 1997 budget passed by parliament was weaker than initially programmed, Directors noted that it

remained consistent with the objectives of no central bank or banking system financing. Directors emphasized the importance of strict adherence to the budget so as to make progress toward a broadly-balanced budget in 1998. In that regard, several Directors noted that interest rates and payments were already lower than programmed and that those savings should be used to reduce the overall deficit rather than to increase spending. Given Bulgaria's high external public indebtedness and the deep loss of confidence from which Bulgaria was emerging, Directors agreed that an ambitious target for the Fiscal Reserve Account (FRA) was essential to maintain confidence, and that the target should be achieved without excessive borrowing.

Directors considered poor revenue performance to be a key risk to the budget, and therefore urged the authorities to step up their efforts to improve tax administration and strengthen the tax system by broadening its base and increasing its efficiency. Directors cautioned that, without sustained efforts to improve revenue performance, the government would increasingly lack the resources needed to carry out its basic functions and achieve its social goals. They therefore welcomed the planned review of the tax system, which would provide the opportunity to put in place comprehensive tax measures in the context of the 1998 budget. In that regard, they underscored the need to improve the taxation of the private sector and strengthen collection of tax arrears. Since it would take time to improve revenue performance, Directors stressed the need for continued expenditure restraint. They therefore welcomed the plans to improve the targeting of the social safety net and the efforts to streamline public administration. They also stressed the importance of timely adjustments to administered prices to keep subsidies within budgeted limits. Several Directors also questioned whether adequate account had been taken of the likely fiscal impact of banking sector problems. A few Directors also advocated a reduction in nonproductive expenditures to release resources for spending on operations and maintenance, on infrastructure, and on the social sectors.

Directors observed that maintaining cost competitiveness would be crucial to the attraction of foreign investment and to support export-led growth. They stressed that the authorities would need to implement strictly the incomes policy applying to state-owned enterprises (SOEs). Wages in SOEs had recovered quickly from the very low levels of early 1997. Further increases should be limited to profitable enterprises that were increasing productivity. A few Directors expressed concern about the already serious unemployment situation. They called for early actions to address that issue; in particular, through measures to improve education and training. Over the medium term, policies should be directed toward maintaining and enhancing labor market flexibility, which would be a key ingredient for promoting employment, encouraging high productivity growth, and facilitating adjustment to shocks under the CBA.

Directors underlined that Bulgaria's transition history showed that enterprise and banking sector reform was essential for durable stabilization. It was therefore crucially important that the authorities implement fully the panoply of structural reforms supported by the Stand-By Arrangement and the

World Bank Financial and Enterprise Structural Adjustment Loan. The authorities' commitment to privatize all state banks, commercial state enterprises, and half of the utilities within the next two years was in that regard viewed as both necessary and encouraging. A few Directors accorded particular urgency to the privatization or liquidation of loss-making enterprises, and suggested that privatization of the remaining utilities could be accelerated. Directors commended the authorities on the privatization results achieved so far, and strongly advised that privatization continue in as transparent a manner and with as high a regard for governance and efficiency as possible. They stressed that the establishment of an effective legal and regulatory framework and improvement in business practices would be essential to that end.

In the meantime, strict financial discipline on banks and state enterprises and effectively restructuring the financial system were essential to avoid the re-emergence of quasi-fiscal deficits, as well as to ensure the effective functioning of the CBA. A fundamental turnaround in the governance of banks was required to prevent the recurrence of the problem of bad loans. Directors viewed passage of the amendments to the Law of Banks, which strengthened the central bank's supervisory powers, as an important step in that direction. They considered it of utmost importance that the strengthened supervisory framework be implemented fully so that the reflow of resources into the banking system was used wisely. The further liberalization of financial markets, including the removal of obstacles to overseas investment, would also be important in preventing the accumulation of excess liquidity in the banking system. A few Directors raised the possibility of increasing reserve requirements for prudential purposes while prudential standards were being strengthened.

Directors encouraged the authorities to pursue vigorously their goal of fighting corruption and organized crime. Respect for the law and effective institutions were crucial for both the development of civil society and the proper functioning of a market economy.

Directors commended the authorities on the maintenance of a liberal trade and exchange regime and the steps taken to further liberalize trade and prices in the energy and agricultural sectors, including the lifting of export bans on agricultural products. They encouraged the authorities to phase out both the temporary export tax on cereals and the import surcharge as soon as possible. Directors welcomed the removal of the restriction on profit remittances by small enterprises, the limit on foreign exchange purchases for tourism, and the maturity restriction on inward portfolio investments. They urged the authorities to complete the liberalization of the exchange and trade system.

In conclusion, Directors urged steadfast implementation of the authorities' policy program in order to unlock the economic potential of Bulgaria and to continue to establish a strong track record. They welcomed the interest of the new government in a successor Extended Arrangement to support a deepening of structural reforms.

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

The Executive Board took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision in concluding the 1997 Article XIV consultation with Bulgaria, in the light of the 1997 Article IV consultation with Bulgaria conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Bulgaria's restrictions on payments and transfers for current international transactions, as described in SM/96/303, are maintained under the transitional arrangements of Article XIV, Section 2. The Fund encourages Bulgaria to eliminate these restrictions, as soon as circumstances permit. (EBS/97/124, 7/2/97)

Decision No. 11545-(97/76), adopted
July 23, 1997

Review Under Stand-By Arrangement

1. Bulgaria has consulted with the Fund in accordance with paragraph 3(c) of the Stand-By Arrangement for Bulgaria (EBS/97/53, Sup. 4, 4/15/97) and the fourth paragraph of the letter of March 24, 1997 from the Minister of Finance and the Governor, Bulgarian National Bank, in order to review performance under the program supported by the Stand-By Arrangement and to establish performance criteria for end-June, end-September, and end-December 1997.

2. The letter dated June 27, 1997 from the Minister of Finance and the Governor, Bulgarian National Bank, with its attached Memorandum of Economic Policies shall be annexed to the Stand-By Arrangement, and the letter of March 24, 1997, with its attached memorandum, shall be read as supplemented and modified by the letter of June 27, 1997.

3. Accordingly, paragraph 3(a)(i)–(iv) of the arrangement shall be replaced by the following text:

"(i) the ceiling on the cumulative change in net domestic assets of the Bulgarian National Bank, or

(ii) the minimum cumulative change in net international reserves in convertible currencies of the Bulgarian National Bank, or

(iii) the floor on the cumulative primary balance of the consolidated government, or

(iv) the ceiling on the overall deficit of the general government, or

(v) the ceiling on the contracting or guaranteeing of new external debt by the general government or the Bulgarian National Bank with an original maturity of up to and including one year, or

(vi) the ceiling on the contracting or guaranteeing of new external debt by the general government or the Bulgarian National Bank with an original maturity of more than one year, or

(vii) the ceiling on the contracting or guaranteeing of new external debt by the general government or the Bulgarian National Bank with an original maturity of more than one year and up to and including five years, or

(viii) the floor on the deposits of the Banking Department of the Bulgarian National Bank, or

(ix) the floor on the balance of the Fiscal Reserve Account, as set forth in Annexes I–II and IV–VIII of the memorandum attached to the letter of June 27, 1997, is not observed, provided, however, that the targets for end-June 1997 under paragraph 3(a)(i)–(iii) and paragraph 3(a)(v)–(ix) shall be indicative; or."

4. The Fund decides that the first review contemplated in paragraph 3(c) of the Stand-By Arrangement is completed, notwithstanding the nonavailability of data for end-June 1997 relating to the target under paragraph 3(a)(iv) of the arrangement, as amended. (EBS/97/124, 7/2/97)

Decision No. 11546-(97/76), adopted
July 23, 1997

3. SRI LANKA—1997 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1997 Article IV consultation with Sri Lanka (SM/97/169, 7/1/97; Cor. 1, 7/17/97; and Cor. 2, 7/21/97). They also had before them a background paper on selected issues in Sri Lanka (SM/97/182, 7/9/97).

Mr. Disanayaka made the following statement:

The Sri Lankan authorities are in broad agreement with the staff assessment as given in the 1997 Article IV consultation Report. My authorities wish to convey their appreciation to the staff for its advice and constructive suggestions.

At the time the last Article IV Consultation Report on Sri Lanka was discussed in 1996, the country was going through a very difficult period, as Directors might recollect. There was a prolonged drought that was seriously affecting many sectors of the economy, not the least agriculture. To add to the trouble, the separatists had intensified their attacks on the capital city, Colombo. These adverse circumstances made the task of economic management more complicated. The authorities, however, met these challenges with great courage and determination. On the political front, further progress was made toward seeking a peaceful solution to the ethnic problem. On the macro front, they made strenuous efforts to keep the budget deficit under control, rein in rising inflation and revive the growth momentum. These efforts were reinforced by the Budget for 1997 presented to Parliament in November 1996.

As a result of all these efforts, the situation began to improve from the beginning of 1997. Favorable weather conditions too contributed their share to the pick up in economic activity. Inflation has been on a downward path, with the moving average increase in June declining to 14.7 from 16.8 in December 1996. With the fiscal consolidation package launched with the 1997 Budget being broadly on track and an anticipated decline in price pressures that might result from good mid-year harvests, the authorities feel confident of achieving the 6-7 percent inflation target planned for end-1997.

There has been a revival of investor confidence too in the first half of 1997, with the abatement of separatist attacks on the capital city and the prospects for a peaceful solution to the protracted ethnic problem looking brighter following an overwhelming victory for the ruling party at the recently held local government elections. This is reflected in an increase in foreign participation in the stock market and an enhanced flow of foreign direct investment. Tourist arrivals too have grown by 21 percent during the first five months of the year compared to the same period last year. A general pick up in growth is further evidenced by an increase of exports by 27 percent, and of imports of intermediate and investment goods by 22 percent during the same period as compared with last year. If these favorable trends were to continue for the rest of the year, achievement of the planned growth target of 6 percent for the year does not appear to be too difficult.

As pointed out in the staff report, reduction of fiscal deficit forms the center piece of Sri Lanka's medium-term adjustment strategy. In consonance with this broad policy, necessary measures have been incorporated into the 1997 Budget toward reducing the deficit by 2 percentage points to 7.6 percent (from 9.5 percent in 1996) through greater expenditure restraint and more effective revenue collection. A freeze on filling up of existing vacancies in the Public Service, numbering about 25,000, is in operation until a comprehensive civil service re-structuring plan is put in place in consultation with the World Bank and the Asian Development Bank. Studies are under way toward formulating such a plan. My authorities are confident that no further pressures for large wage increases in the Public Sector would arise in the medium term once the existing anomalies across Public Service salary scales are addressed through the two-step salary revision that is being implemented.

As regards the Goods and Services Tax which is planned for introduction at the beginning of 1998, my authorities have indicated to the staff that they are more comfortable in introducing the new tax at a revenue neutral rate, in the first instance. Action is being taken accordingly. Once the new tax has settled down fully, a revision could be considered if circumstances so warrant. Such a flexible approval would, in their opinion, ensure a smooth transition to the new system. In the meantime, if any unanticipated shortfall in tax revenue were to occur, my authorities are prepared to take alternative measures to bridge the gap.

The consolidation measures envisaged in the 1997 Budget would be implemented without any reduction in social spending or cuts in capital budget. These efforts would be continued through the medium term with the objective of achieving current account surplus from 1998 onwards and of reducing the fiscal deficit to 3.5 percent by 2001.

In response to weak performance of the economy through most of 1996, the central bank started relaxing the tight monetary stance toward the end of the year after the decline in inflation pressures. Accordingly, the statutory reserve ratio was reduced from 15 percent in January to 12 percent in March 1997. Moreover, non-BOI (Board of Investment) exporters were allowed to raise foreign loans subject to specified limits (BOI exporters already have this facility). The easing of monetary policy led to a rapid decline in interest rates as banks reduced their prime lending rates by around 2 ½ percent. This, coupled with more effective cash management by the Treasury which led to a decline in net credit to government from 47.6 billion rupees at the end of December 1996 to 34 billion in June 1997, put short-term rates on a downward path. This is evident from the decline of Treasury Bill rates (which have a large influence on the short-term rates) from 18 percent end-December 1996 to 10 1/2 percent by end-May 1997.

As mentioned earlier, even though there are positive signs of a pick up in growth in the first-half of the year, my authorities feel that the time is not yet ripe for a tightening of monetary policy. Price increases have been very subdued in recent months and growth momentum, in their view, has not yet stabilized. They are, however, watching the situation carefully to take appropriate action if circumstances so warrant.

Sri Lanka has been maintaining a flexible market-based exchange rate regime. This has served the country well so far. One of the basic aims of the current exchange rate policy is to maintain external competitiveness of the rupee. The market exchange rate for dollar transactions has been fluctuating within the intervention band of the central bank depending on the daily developments in the interbank dollar rate. It is however true that during the last few months the market spot rate for the dollar has been moving close to the central bank selling rate, thus triggering net sale of dollars by the central bank. The situation has changed in recent weeks and the rate has moved close to central bank buying rate. Consequently, there have been net purchases of dollars by the central bank. The authorities are carefully studying the developments in the foreign exchange market.

In the area of structural reform, considerable progress has been achieved in the divestiture of State-owned Enterprises (SOEs) in 1996 and the first half of this year. As recognized in the Selected Issues paper (paragraph 43, page 23) the divestiture program of State Plantation Companies has made rapid progress and it is expected that by the year end, all remaining companies could be divested. The prevailing buoyancy in the stock market would, no doubt, give a fillip to this effort.

In their discussions with the staff, my authorities have explained that it would not seem feasible at this juncture to push ahead with the divestiture of the two State Banks. Instead, action is being taken in consultation with the World Bank to formulate appropriate performance contracts under which the two Banks could be granted freedom to operate as commercially independent entities. Strengthening the financial viability and managerial capabilities of these Banks are also important objectives contemplated under this arrangement. Any subsidized lending undertaken by these banks at the instance of the government would be fully financed through the Budget as in the case of micro credit loans extended under the poverty alleviation program, "Samurdhi."

Regarding strengthening of Banking Supervision, this is one of the areas pursued by the Financial Sector Reform Committee chaired by the Governor of the central bank. Work is already under way for strengthening the regulatory framework and prudential supervision of the central bank, including the enhancing of the capacity of its supervisory staff.

As stated in the staff report (paragraph 34, page 19) my authorities intend to complete the divestiture of the four large SOEs, presently being undertaken (i.e., Sri Lanka Telecommunications, National Development Bank, State Mortgage and Investment Bank and Air Lanka) before the end of the year. Soon after completing this work, they plan to launch a second wave of divestiture covering the remaining SOEs in the following sectors: manufacturing, tourism and hotels and power and energy.

In the area of civil service and pension reform, as mentioned previously, my authorities are working out a comprehensive program for rationalizing the Public Service cadres as well as for formulating a sustainable basis for Pension Schemes.

A Tariff Commission is presently examining the feasibility of further reduction of the tariffs on international trade and conversion of the present three nonzero bands into two nonzero bands. The Commission is also studying the possibilities for harmonizing the BOI and non-BOI tariff items in an integrated tariff structure. It is hoped that the Commission would be able to complete these tasks before the end of this year.

In the Agriculture Sector, the Paddy Marketing Board, the state marketing organization for paddy producers, is being gradually phased out. Over the last two years, its market operations have been negligible. The authorities hope to wind up its operations soon. The wheat flour subsidy has been already reduced by about 75 percent. My authorities intend to phase out the remaining portion too, very soon.

My authorities agree that the existing labor legislation has brought about considerable rigidity to the labor market. They have, however, explained to the staff that making drastic changes to these laws at this juncture would not seem feasible. A phased reform program would be a more acceptable alternative. Accordingly, action is being taken, as a first step, to bring greater flexibility to the labor market by consolidating the existing legislation, improving dispute settlement procedures and reducing the cost of termination.

With regard to statistical issues, work is under way toward formulating a more broad-based Consumer Price Index to replace the outdated consumer price index (Colombo Consumer Price Index). The new index could be ready by the end of the year.

Finally, my authorities would continue with the remaining work in the reform agenda on which considerable progress has already been made and would make every effort to ensure its early completion. As mentioned above, they are keen to start a second wave of structural reforms no sooner the items in the present pipe-line are completed. It would indeed be a great encouragement if the Fund could, in the near future, support these efforts with an ESAF Program.

Mr. Shields made the following statement:

The authorities' determination to qualify for further Fund support under an ESAF is welcome. Success in coping with the difficult economic situation of last year is also commendable. But no one, especially the authorities, should be seduced by the relatively rosy indicators of increasing output, rising per capita income and declining inflation. There is still a huge amount to be done if Sri Lanka is to attain, and remain on, the path of high quality growth.

This means matching good intentions with positive action. Progress in reducing the fiscal deficit has been encouraging, but there should be no let up. Although, relative to the current position, the targets in the paper of 5.8 percent in 1998 and 4.5 percent in 1999 are tough, they are simply steps on the road to serious fiscal consolidation.

I agree with the staff's assessment of the critical measures required to provide a credible base for an ESAF-supported programme. Elimination of the wheat flour subsidy would be a very good start, and the time is ripe, given reductions in the world price. Is there a firm date for this?

Sri Lanka's track record under the previous ESAF—albeit under difficult circumstances—was poor: disappointingly slow progress, incomplete reforms, and several policy reversals. Given this, and given the size of the reform agenda, we should not expect dramatic results in the short-term. But the authorities need to take preparatory steps now to create the platform for durable progress over the medium-term, and it is clear from Mr. Disanayaka's statement that much work is in progress. I would highlight the following as priorities: identifying public enterprises for privatization; agreeing robust performance targets for the commercial banks; establishing a timetable for further trade and tariff reform; and beginning to tackle the civil service and pension system reform agenda set out in the 1996 Public Expenditure Review. All of this implies that a strong 1998 budget will be needed in November: this will be an acid test of the authorities' willingness to undertake radical reform.

Mr. Daïri made the following statement:

Despite a prolonged and painful ethnic strife, Sri Lanka's economy has experienced average growth rates of 5.4 percent over the past five years, which compares well with the performance of developing countries, excluding the fast-growing Asian countries. To catch up with the latter countries, Sri Lanka has adopted an outward, growth-oriented strategy and, since 1995, has deepened the structural reform process. The prolonged drought and related disruption in electricity supply dampened economic activity in 1996 and exacerbated inflationary pressures. In 1997, with the end of the severe drought and resurgence of inflow of foreign investment and tourism, economic activity has rebounded, inflation is under better control, and exports have expanded rapidly.

It is encouraging to note that the authorities are well aware of the importance of reducing the large fiscal deficit and have made a start on a number of measures to consolidate the budget in order to increase national savings and mobilize the resources required for private sector growth. To this end, the authorities have made commendable efforts to implement an ambitious fiscal budget for 1997, which has aimed at reducing current expenditures by 2 percent of GDP, while capital expenditures are projected to stabilize following years of decline. The medium-term fiscal consolidation program aims at reversing the current account position from a deficit of 3.7 percent of GDP in 1996 to a surplus of 2.5 percent in 1999. To achieve this target, the authorities are encouraged to phase out subsidies, privatize or close down loss-making enterprises, and control the wage and pension bills in the context of the planned reforms of the civil service and the pension and social welfare systems. Efforts should also be focused on strengthening the revenue performance. The authorities have reduced personal income and investment taxes in the hope that revenue loss be offset by increased efficiency of tax administration and improved economic activity. The planned introduction of a Goods and Services Tax and the reduction in corporate and income taxes rates for 1998 are steps in the right direction. Should revenue collection fall short of expectation or should expenditures exceed the budget target, the authorities should stand ready to take additional revenue measures to bring the fiscal stance back on track.

Substantial extension of credit by the central bank to the government and the adverse effect of the weather led to increased inflationary pressures in 1996. During most of 1996, the central bank resisted pressures to ease the monetary stance. The relaxation of monetary policy in early 1997, in the context of declining inflation, led to a sharp fall in interest rates. In view of the recent build up of bank liquidity, we concur with the staff on the need to tighten monetary policy to achieve the inflation target, including through intensification of open market operations.

The fragility of the banking system is worrisome. Prudential guidelines are well below international standards, and nonperforming loans, particularly of state-owned commercial banks, are high. In view of the large share of these banks in total banking system assets, their compliance with prudential regulation as well as government guarantees of their loans have cost implications for the budget. To reduce such costs and increase the efficiency and profitability of state-owned commercial banks, the authorities should move ahead with their plan to strengthen their autonomy and performance and insulate them from noncommercial activities, on the one hand, and improve supervision and prudential regulations, on the other hand.

The authorities' structural reform agenda is encouraging. In addition to civil service and banking sector areas, the agenda extends to the labor market, trade and tariff reform, privatization, and elimination of subsidies. Its credibility should be enhanced by a timetable of implementations. We are pleased to learn from Mr. Disanayaka's helpful statement that the authorities are hopeful of obtaining Fund support under an ESAF arrangement for their adjustment and reform programs, and we look forward to an early agreement with the Fund.

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

Mr. Elhage made the following statement:

As noted in the well written staff report and Mr. Disanayaka's helpful statement, economic performance has shown welcome signs of improvement since the last review. More importantly, the authorities are seriously contemplating requesting discussion on an ESAF with the Fund. In this context we would encourage the authorities to continue with their preparatory work in order to permit a meaningful and conclusive discussion as soon as feasible. An early conclusion of an arrangement should consolidate and intensify the reform effort in a more comprehensive manner. Let me briefly focus on the areas that should rank high on the reform agenda.

On fiscal policy, we welcome the steps taken by the authorities to achieve a reduction in the overall fiscal deficit by about 2 percentage points in 1997. If achieved, this clearly represents a step in the right direction. However, we must express concern about the size of the overall public sector deficit which stands at about 9 percent of GDP, and that part of the recent improvements in the fiscal position was effected through cuts in capital outlays. Hopefully these are low priority outlays. In this connection, I fully concur with the staff that a better mix of durable revenue and expenditure measures than presently envisaged would be needed to strengthen the structure of the budget. On the revenue side, with the planned introduction of the GST the authorities will have at their disposal a feasible instrument through which they can generate additional revenue by an adjustment in the rate should that be necessary. Instituting an effective expenditure management mechanism is another area that merits attention. The authorities are also encouraged to contain the public sector wage bill through reform of the civil service to rationalize its structure and improve the efficiency of the administration, phase out transfers to public sector enterprises, and eliminate the subsidy on wheat flour.

With regard to monetary policy, an early tightening is called for. Monetary policy in Sri Lanka has been mainly accommodative in nature. Under an ESAF arrangement the role of monetary policy will have to be enhanced and firmly be focused on controlling inflationary pressure. While the objective of reducing the inflation rate from about 17 percent to 7 percent is welcome, we wonder how this could be achieved under the present stance of monetary and fiscal policies. Staff views would be appreciated.

On the structural front, the reform of the financial sector, which is dominated by the two state-owned commercial banks, should not be delayed lest it endangers macroeconomic stability. The high level of nonperforming loans, especially in the state owned banks which now account for 60 percent of assets, has resulted in a heavy financial burden to the budget and diminishes the scope for efficient financial intermediation. The authorities would be well advised to intensify their efforts to strengthen the banking system, including the restructuring of the state-owned commercial banks, by adopting capital adequacy guidelines, restricting political interference in banking activity, and enhancing the supervisory capacity of the central bank. Given the large percentage of nonperforming loans in the system, the potential costs of resolving such loans in Sri Lanka is undoubtably very high and could have a major negative impact on the budget. It should be recalled that the weak banking sector has been costly to the budget and on confidence. In 1993, the government recapitalized the state owned commercial banks at a cost of about 3.5 percent of GDP in order to meet the capital adequacy requirements and again in 1996, it cost the government about 2 percent of GDP to cover political loans that were in default. Unless these issues are resolutely addressed it is difficult to see how macro-economic stability can be attained.

In conclusion, we urge the authorities to implement the preparatory measures identified during the consultation process so that a discussion on an ESAF can commence in order to consolidate the initial gains made. Delays in implementing necessary reform in a comprehensive manner will only increase the magnitude of the required adjustment.

With these remarks, we wish the authorities every success in addressing the challenges they face ahead.

Mr. Han made the following statement:

It is encouraging that the Sri Lankan economy is expected to stage a rebound in 1997, along with indications of more favorable weather conditions, an improvement of business confidence, and a pick-up in tourist arrivals. In order to sustain and promote growth on a longer term basis, the authorities' emphasis on the reduction of fiscal deficit and the strengthening of structural reforms is commendable. The staff has made a thorough assessment of the recent economic developments and constructive recommendations in their papers. I broadly agree with the staff appraisal and therefore would like to focus my remarks on the following points.

While the persistently high fiscal deficit is at the root of many economic problems, we appreciate the authorities' aim to reduce the overall deficit to 7.6 percent of GDP in 1997. This would also help reduce the burden on monetary policy in containing inflation. Nevertheless, close vigilance is essential in order to attain the fiscal target, especially since the staff has pointed out several risks which could lead to a higher deficit. Fiscal adjustments should be made promptly in cases of clear evidence of deviations from revenue or expenditure estimates. As to the exchange rate policy, we agree with the central bank's move to resume net purchases of foreign exchange so as to allow for faster depreciation of the Sri Lankan rupee and to offset the effect of the large real appreciation of the exchange rate. However, caution should be taken not to induce inflationary pressure.

To generate and sustain faster growth with lower inflation over the medium term, it is essential to formulate bold policies to ensure a substantial increase in savings and to carry out structural reforms. A sustained reduction in the fiscal deficit should be engineered through durable revenue and expenditure measures. We welcome the authorities' initiatives in putting the consolidation of public finances over the medium term at the center of its economic program. While the introduction of the Goods and Services Tax in 1998 can help broaden the tax base, consideration should be made in due course on the need to introduce additional measures to strengthen the revenue-to-GDP ratio. Measures on the expenditure side are equally important in meeting the fiscal target over the medium term. This would involve the reforms of the civil service and pension systems as well as social welfare programs. In respect of devolution proposals, the authorities should carefully study their fiscal implications.

While Sri Lanka has considerably improved the resilience of the economy through structural reforms over past few years, it can further capitalize on these gains and achieve a higher growth potential by accelerating the reforms. In this regard, we share the staff's view that priorities should be given to financial sector reform, particularly on the banking system, and trade sector.

With these remarks, we wish the authorities every success in engineering their economy toward faster growth.

Mr. Melese-d'Hospital made the following statement:

Many of the points I would like to make have been picked up by other speakers, so I will be brief. I would like to thank the staff for a comprehensive and enlightening set of papers. They present a solid assessment of the key policy challenges facing the authorities. Notwithstanding the important progress made in a number of areas since the beginning of reforms two decades ago, the fact remains that partial reforms lead to partial results. In this case the results are steady but unspectacular average GDP growth in the range of 4 percent per annum which, taking into account a population growth rate of 1.4 percent per annum, is insufficient to provide a significant boost to living standards in any but the long run. Thus, as the selected issues chapter on lessons from East Asian comparator countries points out, since 1960 Sri Lanka's real per capita income has failed to even double, whereas the four comparators (Indonesia, Korea, Malaysia, and Thailand) have raised their real per capita income levels to between four and eight times their 1960 levels. Clearly, despite its efforts over the past two decades Sri Lanka has failed to initiate a strong virtuous cycle of savings, investment, and growth capable of radically improving living standards, and in my view this is the overarching challenge for the authorities today.

As the discussions between the staff and the authorities make clear, the authorities are considering embarking upon a new round of reforms capable of placing Sri Lanka on that higher growth path which could be supported by an ESAF program. I would strongly encourage them to do so, and I will offer a few suggestions for reforms in three key areas designed to jump-start such a process.

Both because of the small size of its economy and because of its strategic location, Sri Lanka must of necessity follow an outward-oriented development strategy including greater openness to trade and investment. The staff's recommendations to simplify and streamline the tariff regime and to reduce the maximum tariff rate from 35 percent to 15 percent are a good starting point. Quick privatization of large state enterprises already in the privatization pipeline (such as Sri Lanka Telecom, the National Development Bank, the State Mortgage Investment Bank, and Air Lanka) will send an important message to investors on the authorities' intended policy course, but how such privatizations treat foreign investors will be key in determining Sri Lanka's future access to foreigners' capital and expertise. A second wave of divestment should quickly follow these first four privatizations, and should go as far as possible toward removing the state entirely from the economy. In this regard, the "sectoral approach" described by the authorities sounds to me suspiciously like a strategy for selective delay, and I would advise a more broad-gauged and expeditious approach.

The cornerstone of any strategy for accelerated growth must be fiscal consolidation. Sri Lanka already benefits from private savings rates in line with the East Asian high-growth comparators, but whereas they have public savings rates of between 7 and 15 percent of GDP, the Sri Lankan government dissaves. Clearly, as the staff points out, additional increases in total savings needed to finance growth will have to come in large part from increased public savings. In this light the authorities' stated intention to reduce the central government budget deficit excluding grants from 9.5 percent of GDP in 1996 to 4.5 percent in 1999 is extremely welcome. Of course, privatization can make a contribution here, but this will have to be augmented by substantial cuts in current spending—particularly on subsidies and transfers, wages and pensions, and military spending—and by new revenue measures.

Fiscal consolidation will provide the resources, and greater openness the opportunity, for investment and growth, but financial intermediation will be needed to bring the two together. In this light, I noted with dismay that the Sri Lankan banking system is still dominated by the two leading state banks, and further that the authorities have no intention of privatizing them during the current government's tenure. I would argue that, more than anything else, such a move could provide the decisive signal to the international community that a sea-change had occurred in Sri Lanka's policy course, and I strongly urge them to consider the high potential dividends of such a move.

Mr. Al-Tuwaijri made the following statement:

The economic performance of Sri Lanka has improved over the past 12 months. Growth has been rebounding while inflation has been decelerating. Progress has also been made in enhancing the fiscal position. Strengthening this performance further in line with the authorities' appropriately ambitious objectives requires sustained policy efforts to increase domestic savings and reduce structural rigidities.

Strengthening the fiscal position rightly tops the policy agenda. The planned fiscal adjustment in 1997 is an important step. In this regard, I welcome the authorities' estimates that the fiscal outcome will be even better than budgeted. At the same time, given the risks detailed in the staff paper, vigilance is still needed. Moreover, the authorities should strive to achieve the planned strengthening of the expenditure structure.

Over the medium term, attaining the fiscal objectives depends, to a large degree, on success in implementing a comprehensive reform of the civil service and pension systems. In view of the sensitivity of these issues and the time needed to implement them, it is important to start the process at an early stage. Efforts are also needed to enhance the buoyancy of revenues.

Strengthening the fiscal stance will improve the policy mix and reduce pressure on monetary policy. At the same time, a tight monetary stance is still needed in order to achieve the inflation target. Increased use of open-market operations will help achieve this objective. However, more accelerated depreciation of the rupee during the rest of the year may complicate the inflation reduction efforts.

In addition to consolidating its efforts on the macroeconomic front, the government can best meet the challenge of achieving high sustainable growth by making an all-out effort to encourage private sector investment. In this regard, the authorities are encouraged to push ahead with the comprehensive reform of the financial sector. The importance of an efficient financial sector to investment and growth cannot be overemphasized. Thus, forceful action to address the issue of bad loans by improving classification and provisioning standards is needed. Strengthening banking supervision and prudential regulations is also a priority. Moreover, I endorse early action to increase the autonomy of the two state commercial banks.

The success of the authorities' efforts also hinge on progress in privatization, reforming the agricultural sector, and increasing labor market flexibility. In this regard, I commend the authorities' efforts in the privatization area. The plan to continue the divestment effort bodes well for the future. Strengthened efforts, however, are still needed in the agricultural and labor markets. The staff makes some good recommendations in these areas. Finally, I wish the authorities every success in meeting the challenges that lie ahead.

Mr. Rodriguez made the following statement:

Let me first commend the staff for an interesting and well written set of papers. After a severe drought in 1996, macroeconomic activity in Sri Lanka has recovered. Real GDP is expected to grow at a rate similar to what had been achieved in the past, while inflation is projected to fall and the balance of payments position should remain stable, supported by a recovery of exports and tourism. Nevertheless, in the long run, fiscal adjustment and structural reforms are necessary to foster growth potential.

Sri Lankan authorities are well aware of the need for fiscal consolidation. Some specific measures have already been adopted and others will be implemented so as to achieve a gradual reduction in the deficit over the following years. Nevertheless, I share with the staff its concern for all the risks they point out in the program and I would like to stress a few, adding some comments.

Income tax collections are likely to fall, because of the tax cuts and investment incentives. Yet, according to the staff report, economic recovery and improvements in tax administration are expected to compensate for it. Perhaps, the staff could discuss further on the possible effect on revenue collection of economic recovery and on the success achieved so far in the tax administration reform, since there have missions of the Fiscal Affairs Department since 1990.

The employment freeze considered may be hard to enforce as the staff suggests. In this regard, it would be interesting to know what is the annual increase in public employment due to hiring new school teachers and whether the 25,000 reduction is net of this increase.

Another source of concern is that the prior attempt to eliminate subsidies was reversed. The question is if in this case there is enough support for this measure to be sustained in the future.

The medium-term macroeconomic projections show a decline in interest payments of 0.5 percent of GDP in 1998 and 1.1 percent of GDP in 1999 with respect to the 1997 level, which account for more than 25 percent of the expected improvement in the overall balance of the fiscal sector. However, according to the staff report, interest costs might rise because of greater reliance on market based mechanisms to conduct monetary policy. Maybe the staff could provide an estimate of the impact of a higher than programmed interest rate on the central government and the central bank balances, so as to better assess this risk.

All these elements suggest that additional measures will probably be needed to achieve the fiscal targets. Government authorities have indicated their willingness to do so, including an increase in the national security levy. However, cuts in social programs and capital spending might still be needed in order to reach the targets.

The staff is concerned about the real exchange rate appreciation registered during 1996 and has suggested some inflation targeting. The relaxation of the monetary policy, motivated either by the weak performance of the economy or by the government financial needs, induced a real appreciation of almost 12 percent. As a consequence, monetary policy should be tightened as suggested by the staff and it is rather reassuring that the exchange rate has already been depreciating in real terms so as to preserve export competitiveness, shifting the central bank net position in the market from seller to buyer. Adopting an inflation targeting policy framework, however, could lead monetary authorities to drop the exchange rate band system in case that reserve purchases threatened the monetary program. This is a change that the authorities might not be ready to make, and understandably so, because the exchange rate system has served them well so far.

There are many areas in which structural reforms are needed and in which progress has been slow. The commitment to complete the privatization program and to strengthen banking supervision is promising. Although there may be some important political constraints, the second wave of privatizations should be pushed forward, given the time these processes take.

The authorities have made clear that the privatization of the two state owned banks is not feasible at this point. The performance contracts should bring some efficiency gains in the financial sector. Yet, maybe a deeper reform of these banks might be possible, such as a merge of the two banks or opening one of them to private capital investment under a management contract.

The reform of the civil service and pension system is already being addressed. Nevertheless, given the high up-front political cost of these reforms with benefits that are substantial only in the long run, this type of reform usually takes a long time. For this reason, authorities are encouraged to pursue it in a steadfast manner. With these comments, I wish them every success.

Ms. Kouprianova made the following statement:

First of all, allow me to thank the staff for the set of interesting papers for today's discussion.

The economy's performance in 1996 was not particularly impressive, although the authorities have undertaken some corrective measures aimed at improving the overall macroeconomic situation. A long policy agenda is ahead. We are, however, encouraged by their readiness, as indicated in Mr. Disanayaka's statement, to proceed further with reforms, and, to this end, to develop and to adopt a set of concrete and consistent measures on all policy fronts. We also welcome their intention to work toward implementing these measures to qualify for the Fund support, as in a present country's standing, the ESAF program seems appropriate to assist in achieving the authorities' ambitious policy objectives.

We share the thrust of the staff appraisal. At this point of the discussion, I will limit myself to emphasizing two issues.

We share the assessment that prudent fiscal policy is a cornerstone of the authorities' adjustment effort. The 5 percent of GDP reduction of the central government budget deficit by 1999 is an ambitious target, and the first step to achieve it is meeting the fiscal target for 1997. All envisaged measures for 1997 are in the right direction, and if timely implemented, will put this target within reach. However, the reduction of the amount of fiscal deficit only is not enough, and here we support the view of other directors that more attention should be given to the improvement of quality of fiscal adjustment. The authorities concentrate their fiscal adjustment effort mostly on the expenditure side. We share the staff's view that there is some room for revenue increase, and that the medium-term program needs to include revenue enhancing measures.

Turning now to the labor market issues. Liberalization of the labor market is extremely important, as the persisting high unemployment level is undermining stabilization achievements. The authorities' current efforts to remove inconsistencies in legislation are welcome. However, more aggressive pace in this area is needed. While sympathizing with the authorities' argument about sensitivity of this issue, labor market reform should be initiated as soon as possible in order to adapt an appropriate legislation to the transforming economy, to minimize the labor market rigidities, thus stimulating the development of a modern private sector. The ESAF program will be an appropriate framework to assist the authorities in this area.

With these remarks we wish the authorities every success in their transformation efforts, and hope that the envisaged policy measures for 1997 will be implemented without deviation, thus building a foundation to further progress of the economy.

Mr. Goffinet made the following statement:

The weakness of Sri Lanka's economy is partly due to exogenous factors and partly to decades of lax financial policies. Past reform efforts were not strong enough to put Sri Lanka on a better growth path. In 1996, a prolonged drought and power shortages depressed output growth to its lowest level since 1989, increased the inflation rate to 22 percent, and helped shrink international trade. The recent modest improvement of Sri Lanka's macroeconomic situation and the increase in investor confidence by no means relieve the authorities of the necessity to continue important economic reform efforts aimed at boosting growth.

Since I broadly agree with the staff appraisal, I will limit my comments to highlighting a few priorities:

First of all, further action is needed to correct the present unsustainable fiscal situation and move toward macroeconomic stability. For years inflationary pressures have been fed by large fiscal deficits, whose financing has diverted money from productive uses and continually added to the state deficit. While recognizing that this situation severely constrains the government's options, I urge the authorities to miss no opportunity to reduce spending and keep the deficit low, and to increase foreign investor confidence. The inclusion of the consolidation of public finances as a core element of the government's medium-term program is most welcome.

As to structural reforms, I especially urge the authorities to continue their efforts to improve the functioning of the financial system. A healthy banking sector operating in a generally sound legislative framework under the control of a well functioning system of bank supervision is essential for mobilizing domestic savings and promoting economic growth.

Finally, we welcome the authorities' determination to qualify for further Fund support under the ESAF.

Mr. Mafararikwa made the following statement:

We also welcome the improvement of the macroeconomic environment that is under way in 1997, and we hope that this trend, plus efforts to seek a peaceful resolution to the ethnic conflict and the timely implementation of reform measures that are in the pipeline, will form a solid basis for the authorities to move quickly to an ESAF-supported program.

We wish the authorities well in their endeavors.

Mr. Joyosumarto made the following statement:

We are encouraged by Mr. Disanayaka's helpful statement which is emphasizing the commitment of the Sri Lankan authorities in adhering to the staff recommendations and to build on the achievements established thus far. The Sri Lankan authorities have recognized the need to sustain the process of medium term fiscal consolidation and to accelerate the pace of structural reforms which are vital for increasing growth and maintaining macroeconomic stability. As many speakers have also touched on the major issues, I would like to make the following remarks for emphasis.

We welcome the direction and efforts made by the authorities to reduce the overall deficit and the public dissaving through greater expenditure restraint especially in the civil service and pension systems. Moreover, we support the staff recommendations to put in place a more flexible pricing system to prevent a reemergence of subsidies, framing the 1998 budget with an adequate reserve for military spending and the implementation of the GST.

On the issue of privatization, we encourage the authorities to remain committed to completing the divestiture of the four large state owned enterprises by the end of the year and to begin on the second wave of divestiture.

On this front, it is encouraging to note that the Sri Lankan authorities are making efforts to strengthen bank supervision and to grant the state owned banks greater operational autonomy. Within the context of restructuring in the banking sector, there is a sequence of events needed to be implemented in strengthening the banking industry. The first is the need for the authorities to impose prudent regulations through legislative changes and the strengthening of the financial viability and managerial capabilities of this industry. The second important policy is to gradually deregulate banking operations over a certain time period to improve efficiency and competitiveness.

Finally, to conclude I would like to wish the Sri Lankan authorities all the success in the future in broadening and deepening the Sri Lankan economy.

Mr. Otazú made the following statement:

Sri Lanka experienced a difficult economic and financial situation during the first half of 1996 due mainly to several adverse developments, such as severe droughts and ethnic conflicts that exacerbated the economy's difficulties. In spite of these problems, the authorities have been taking measures to restore confidence in the macroeconomic environment while making progress toward a peaceful solution for the ethnic problem.

In order to sustain higher growth with low inflation in the medium term, bold policy actions are needed to ensure a substantial increase in domestic savings and the more efficient allocation of scarce resources.

As I broadly agree with the thrust of staff appraisal, I would like to limit myself to the following few points:

The reduction of the persistently high fiscal deficit, which is at the root of many economic problems, is essential to the stabilization efforts. The attainment of the fiscal target requires full implementation of planned tax and expenditure reforms. These efforts should encompass permanent actions to strengthen budgetary monitoring and control procedures. However, in order to reduce an excessive burden on monetary policy, the authorities should stand ready to make further adjustments on both the revenue and expenditure fronts.

The monetary policy stance should be oriented to containing inflationary pressures. In this regard, I concur with the staff that tighter reserve monetary management through dynamic open market operations and other monetary tools are essential for maintaining a low level of inflation.

Under present circumstances there seem to be no alternatives to continuing with a managed floating exchange rate policy to protect the balance of payments' position. The managed part of the floating should not, however, prevent market forces from exerting their influence.

On structural reforms, the authorities are to be commended for the notable progress in privatization, despite a strong resistance. Further efforts in this area are essential and should give priority to financial sector reform and effective bank supervision.

Finally, the authorities' intention to request further Fund support under the ESAF should be backed by concrete a priori measures.

With these remarks, I wish the Sri Lankan authorities the very best in their future.

The staff representative from the Asia and Pacific Department, turning to the question of the wheat subsidy, indicated that at the time of the mission, the staff had estimated that an increase in the wheat flour price of about 5 percent would be needed to meet the budget goals. Since then, however, international prices had softened further, so the urgency of the increase had diminished. No price increases had taken place, and they were not expected until the end of the third quarter of 1997. Moving to a flexible market-based pricing mechanism which would obviate the need for discretionary price adjustments and constitute a structural reform was more important than an immediate price increase. The government had made a decision to move to a flexible pricing mechanism, and the staff expected that at the time of the final price adjustment the government would also announce a move to a flexible pricing mechanism. A further step would also be required allowing private sector imports and distribution of wheat flour.

As Sri Lanka did not have an unemployment benefits system, the costs of redeployment or retrenchment under the adjustment program resulting from privatization and from civil service reform would need to be covered through external assistance, the staff representative said. The authorities had requested the World Bank's assistance, and the Bank had indicated its willingness to consider the request in the context of the overall structural reform program.

Sri Lanka's tax system was not buoyant, and the economic recovery had not led to a pick-up in revenues, the staff representative indicated. The move toward a GST would help in that respect. Apart from that, the authorities should refrain from granting ad hoc exemptions to industries whenever asked. The Fund had been providing technical assistance in the area of tax administration, the staff representative continued. More work remained to be done, in particular to prevent any leakage through the board of investment scheme. The integration of the board of investment with the customs regime should help prevent some of the smuggling that had been occurring. It should also be noted that the tax base had been widened recently by including public sector employees.

Although greater reliance on market-based instruments in the conduct of monetary policy could, by itself, lead to higher interest rates, other factors could mitigate against an increase, the staff representative indicated. With further fiscal consolidation, pressures on real interest rates were expected to ease. In the recent government borrowing from the so-called captive sources, administered interest rates had been kept fairly high—in the region of about 14 percent—and were unlikely to increase substantially with a move to market interest rates. In addition, privatization receipts were expected to be large in 1997, and would be used to reduce public debt. That would also help ease upward pressure on interest rates. Consequently, although the combined effect of those factors could result in an increase in interest rates, it was unlikely to be large.

The targeted reduction in inflation from 17 percent to 7 percent was achievable, the staff representative suggested. The most recent data indicated point-to-point 12-month inflation rate at 4 percent, and the most recent quarterly inflation numbers were in the region of 2–3 percent on an annualized basis. Notwithstanding those positive indicators, a relaxation in monetary policy would not be appropriate. The decline in inflation had been largely due to a decline in food prices which, after increasing by 19 percent in 1996 because of the drought, had increased by only 1 percent in 1997. Nonfood price inflation had come down somewhat as well, from about 11 percent to just under 10 percent, but it needed to be brought down further.

Mr. Disanayaka indicated that the wheat subsidy would by phased out by the end of September. The authorities were also working out a flexible pricing mechanism to replace administered pricing.

Three large entities—Sri Lanka Telecom, Air Lanka, and the State Mortgage Bank—were included in the first wave of privatization, Mr. Disanayaka stated. The process was well advanced, and the authorities expected to complete it before the end of the year. A second wave of privatization would be based on a sectoral approach, with the most suitable sectors to be privatized first—hotels, tourism ventures, followed by electricity and others. In response to criticism, the government had decided to restructure some of the enterprises prior to placing them on the market.

In response to the slack in the economy in the second half of 1996, the central bank had relaxed monetary policy and reduced interest rates, Mr. Disanayaka continued. Although growth had resumed since, the pickup was not sufficiently robust to convince the authorities the time had come to tighten policy. Credit growth in the private sector had been slow, and M2 had been growing slowly as well. However, the authorities remained prepared to tighten policy when growth strengthened sufficiently.

The 25,000 or 26,000 public sector vacancies would not be filled until the World Bank assisted restructuring program was put in place, Mr. Disanayaka indicated. The authorities were moving cautiously, in a carefully planned and organized manner, mindful of the necessity to avoid the mistakes made in 1994 and 1995 in a hurried restructuring of the civil service. The World Bank was also assisting the authorities in the area of pension reform. The goal was to place the pension system on a more sustainable basis and to encourage private sector pension schemes.

Sri Lanka had a well-established social safety net, Mr. Disanayaka stated. The Samurdhi program covering about 1.8 million families was well targeted. The government was considering ways of rationalizing and strengthening it in order to provide support to the reform and restructuring program. However, the government's primary concern was how to create new employment opportunities for displaced workers. The challenge was all the more pressing as Sri Lanka faced the problem of educated youth unemployment which had fueled two rebellions in the last decade. Clearly, private sector expansion would be critical to the economy's ability to absorb newly displaced workers as well as the long-term unemployed.

Sri Lanka had a tradition of strong labor movement and well-organized labor unions, Mr. Disanayaka continued. Nevertheless, the rank and file recognized the need for more flexible labor laws—including the termination of employment laws, dispute settlement, and the need to streamline existing labor legislation. The government's long-term goal was to move toward a more flexible type of arrangement whereby hiring as well as job termination would be made easier.

In response to a question from Mr. Daïri regarding the timetable for a discussion of the ESAF program, the staff representative from the Asia and Pacific Department said that the 1998 budget would be critical in that respect. The staff expected to conduct further discussions with the authorities during the Annual Meetings—five or six weeks before the budget speech—to assess the authorities' plans for the budget as well as those for a number of other structural measures, and then to evaluate the situation after the budget speech. Full-fledged ESAF negotiations could follow thereafter.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the staff appraisal. They commended the steps taken by the authorities to regain control over the fiscal situation in the second half of 1996 and noted the improved economic outlook for 1997. The main challenge now facing the authorities was to build on that success to make an urgent and comprehensive effort to strengthen macroeconomic policies and accelerate structural reforms in order to address the longstanding economic problems that were impeding Sri Lanka's growth potential.

Directors noted that the high fiscal deficits of the preceding several years had been the source of many of Sri Lanka's economic problems, and emphasized that fiscal consolidation must therefore be the key ingredient in the adjustment strategy to stabilize the economy and improve its growth prospects. To that end, they welcomed the planned reduction in the overall deficit by 2 percent of GDP in 1997, and urged close vigilance and prompt corrective actions to ensure that the target was not missed. In particular, they stressed the importance of removing the subsidy on wheat and putting in place a flexible pricing system for wheat flour to prevent the re-emergence of a subsidy.

Directors emphasized the importance of achieving a significant reduction in the overall budget deficit in 1998 and beyond. They stressed that it was also important to strengthen the structure of the budget and improve the buoyancy of the tax system, and noted that the introduction of the Goods and Services Tax with the 1998 budget would be vital.

On the expenditure side, the most pressing need was to launch a comprehensive reform of the civil service and pension systems to control the wage and pension bills, to improve the targeting of social welfare programs, and to phase out transfers to public entities as they continued to be restructured, as well as to improve the overall expenditure management.

Directors stressed that it would be important to keep inflation well within the single-digit range to signal the authorities' serious commitment to macroeconomic stability. That would require an early tightening of the monetary policy stance through more aggressive open market operations. On exchange rate policy, Directors were of the view that, although the policy of a managed float remained appropriate, it would be important to limit the extent of intervention and to allow the exchange rate to respond more freely to market forces.

Directors noted the progress achieved in some areas of structural reform, notably privatization, the elimination of overgenerous early retirement benefits, and the rationalization and consolidation of social welfare programs. However, they regretted that Sri Lanka's growth had been severely constrained by the slow progress in addressing structural weaknesses in several key areas, and urged the authorities to press ahead with an ambitious program of structural reforms. Specifically, Directors pointed out that priority should be given to strengthening the financial system and increasing its efficiency, which was crucial for ensuring medium-term macroeconomic stability. Foremost in that regard were actions to improve the financial health of the two state-owned commercial banks, which should be given greater commercial autonomy, including through legislative changes. The standards of prudential regulation and the effectiveness of financial system supervision would need to be strengthened. As for other structural reforms, the momentum on privatization should be maintained and enterprises identified for further privatization, trade reforms should be reinvigorated, and greater priority should be given to reforms aimed at promoting competitive market forces in agriculture and reducing rigidities in the labor market.

Directors welcomed the authorities' wish to obtain Fund support under a new three-year ESAF arrangement, which they saw as an encouraging sign of the authorities' commitment to medium-term adjustment. To establish a credible base for an ESAF-supported program, Directors stressed that it would be important to introduce a structurally sound budget for 1998 and to move from the design phase of structural reforms to the establishment of firm timetables for specific actions in the implementation of preparatory measures in priority policy areas.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/97/75 (7/21/97) and EBM/97/76 (7/23/97).

4. JAPAN—ADMINISTERED ACCOUNT—AMENDMENT

As requested by the government of Japan (memorandum dated July 11, 1997), the Instrument established pursuant to Decision No. 9387-(90/39), adopted March 19, 1990, shall be amended as reflected in Annex II to EBS/97/134 (7/16/97).

Decision No. 11547-(97/76), adopted
July 21, 1997

5. RELATIONS WITH AFRICAN DEVELOPMENT BANK AND INTER-AMERICAN DEVELOPMENT BANK—INVITATION TO ATTEND EXECUTIVE BOARD MEETINGS ON INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES

The Executive Board approves the proposal to invite representatives of the African Development Bank and the Inter-American Development Bank to Executive Board meetings on the Initiative for Heavily Indebted Poor Countries, as set forth in EBD/97/90 (7/18/97).

Adopted July 21, 1997

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/97/119 (7/18/97) and by Advisors to Executive Directors as set forth in EBAM/97/119 (7/18/97) is approved.

APPROVAL: December 1, 1997

REINHARD H. MUNZBERG
Secretary