August 11, 1999
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INTERNATIONAL MONETARY FUND

# Minutes of Executive Board Meeting 98/69

10:00 a.m., June 26, 1998

## Contents



## Decisions Taken Since Previous Board Meeting

**Executive Board Attendance**

S. Sugisaki, Acting Chairman

| **Executive Directors** | **Alternate Executive Directors** |
| --- | --- |
| | S.M. Al-Turki |
| | C.X. O'Loghlin |
| R.F. Cippa | |
| B. Esdar | |
| | F. Mercusa, Temporary |
| | L. Pinzani, Temporary |
| D.Z. Guti | |
| | M. Carlens, Temporary |
| | A.L. Coronel, Tempoary |
| W. Kiekens | V. Rigász, Temporary |
| K. Lissakers | B.S. Newman |
| | M. Budington, Temporary |
| J.-C. Milleron | R. Fernandez |
| | H. Paris, Temporary |
| | M.A. Hammoudi, Temporary |
| | A. Vernikov |
| | I. Zakharchenkov, Temporary |
| G. O'Donnell | H. Hagan, Temporary |
| | W.F. Abdelati, Temporary |
| | A.G. Karunasena |
| | C.M. Gonzalez, Temporary |
| | J. Guzmán-Calafell |
| | Y.G. Yakusha |
| K. Yao | |
| | S. Hinata, Temporary |
| Zamani, A.G. | Phan M.H., Temporary |
| Zhang Z. | Lu A., Temporary |
| A.G. Zoccali | O. Otazú, Temporary |

A.S. Linde, Acting Secretary
A. Mountford, Acting Secretary
P.J. Kunzel, Assistant
P. Cirillo, Assistant

**Azerbaijan Republic—1998 Article IV Consultation; Enhanced Structural Adjustment Facility—Review Under Second Annual Arrangement; and Review Under Extended Arrangement**

Staff representatives: Owen, EU2; Schadler, PDR

**Kyrgyz Republic—Enhanced Structural Adjustment Arrangement**

Staff representatives: Catsambas, EU2; Muñiz, PDR

**Marshall Islands—1998 Article IV Consultation**

Staff representatives: C. Lee, OMD; Muñiz, PDR

**Federated States of Micronesia—1998 Article IV Consultation**

Staff representatives: C. Lee, OMD; Muñiz, PDR

**Also Present**
IBRD: R.E. Christiansen, K. Kodera, P.L. Rodriguez, Europe and Central Asia Regional Office; H.M. Codippily, East Asia and Pacific Regional Office. Asia and Pacific Department: W.S. Tseng, Deputy Director; K.M. Meesook. European II Department: J. Odling-Smee, Director; G. Bélanger, T. Catsambas, J. Dalsgaard, D.G. Fanizza, L. Hansen, D.G. Jones, P.M. Keller, D. Owen, T.O. Saavalainen. Fiscal Affairs Department: P.S. Heller, Deputy Director; M. Petri. Legal Department: R.C. Baban. Monetary and Exchange Affairs Department: R.K. Abrams. Policy Development and Review Department: S. Chami, J. Mongardini, C.G. Muniz, S.M. Schadler. Research Department: F. Larsen, Deputy Director. Secretary's Department: P. Gotur, A. Mountford, B.A. Sarr. Office of the Managing Director: M. Cross, Personal Assistant to the Managing Director; B. Christensen, C.S. Lee. Advisors to Executive Directors: P.A. Akatu, R.J. Heinbuecher, N. Jadhav, J.M. Jones, H. Kaufmann, M.-H. Mahdavian, H. Ogushi, E. Rodriguez, O. Sein, M. Sobel. Assistants to Executive Directors: J.A. Akhmetova, A.S. Alosaimi, T. Belay, N.R.F. Blancher, J.G. Borpujari, S.A. Bakhache, I.-K. Cho, M.A. Cilento, J.C. Estrella, K. Kpetigo, T.-M. Kudiwu, A. Lucenti, T. Presečan, Qi J., O. Schmalzriedt, U.Y. Tilyayev, G. Vigliotti, M. Vismantas, Vongthieres O.

## 1. REPORT BY MANAGING DIRECTOR

The Managing Director reported on his recent travel to Strasbourg, France, where he addressed the Parliament of the Council of Europe.

## 2. AZERBAIJAN REPUBLIC—1998 ARTICLE IV CONSULTATION; ENHANCED STRUCTURAL ADJUSTMENT FACILITY—REVIEW UNDER SECOND ANNUAL ARRANGEMENT; AND REVIEW UNDER EXTENDED ARRANGEMENT

The Executive Directors considered the staff report for the 1998 Article IV consultation with the Azerbaijan Republic, the midterm review under the second annual arrangement for the Azerbaijan Republic under the Enhanced Structural Adjustment Facility (ESAF), and the third review under the Extended Arrangement (EBS/98/99, 6/12/98). They also had before them a background paper on recent economic developments in the Azerbaijan Republic (SM/98/139, 6/12/98).

Mr. Cippá made the following statement:

> Real GDP had declined by 70 percent over the last three years. Inflation was soaring, the exchange rate rapidly depreciating, and international reserves heading toward zero. The situation seemed to get completely out of control. The country described here was Azerbaijan in 1995.
>
> Fast forward: GDP growth is expected to amount to 7 percent. Inflation should remain below 5 percent. The exchange rate continues to appreciate, and the international reserves are building up swiftly. That again is Azerbaijan, but this time in 1998.
>
> Within only three years, Azerbaijan has indeed made a big jump forward. This is not only true for the macroeconomic picture. Also daily life has changed for the better. Private initiative is flourishing, especially in Baku. The supply of consumer goods has improved tremendously. These achievements are the result of a sound economic policy. This policy has mainly been based on three pillars, first, on pursuing macroeconomic stability, second, on liberalizing the economy, and third, on a rapidly increasing cooperation with foreign investors, mainly in the oil sector.
>
> However, despite early and rapid progress, the authorities continue to face severe challenges. So far, strong economic growth did not lead to a significant reduction in the level of poverty. Moreover, huge differences remain as regards the performance of the various sectors of the economy. On the one hand, the oil sector and construction are booming. On the other hand, the large manufacturers that played an important role in the time of the Soviet Union and still employ a large number of people continue to perform poorly.
>
> During these years of rapid change, Azerbaijan has tied a close relationship with the Fund. As indicated in the concise and well-written staff report, it benefitted from a substantial amount of technical assistance. This advice, together with the guidance provided by the mission team, the resident

representative, and the resident advisor has helped my authorities to overcome many obstacles that seemed unsurmountable at a first glance.

In 1997, Azerbaijan's economic performance was impressive. GDP grew by almost 6 percent, much faster than the year before. Equally impressive was the performance on financial policies. Inflation was close to zero and the deficit on a cash basis well manageable. The exchange rate appreciated by about 5 percent. Although the external deficit was slightly higher than expected, it was more than fully financed by a strong inflow of capital (mainly going to the oil sector). Thus, international reserves increased again. The external debt remained low. Important progress was also achieved on structural issues. This positive picture remains essentially valid as regards the first quarter of 1998. All end-March performance criteria were met.

In the first months of this year, fiscal revenues were lower than expected due to the sharp drop in the oil price. In addition, revenues suffered from the decision to temporary halt oil exports in the hope that the oil price would recover soon. As we know, this did not materialize. My authorities acted swiftly to counter the decline in revenues. A considerable amount of discretionary capital and current spending was postponed. As a result, the deficit over this period was substantially lower than assumed in the program. It is noteworthy that despite the revenue shortfall, the government remained current on payments for pensions and wages, and the arrears toward water and energy companies were reduced according to the program.

With unexpectedly large capital inflows in the second half of 1997, and inadequate instruments to sterilize, reserve money grew rapidly. However, this trend was reversed in the first quarter of 1998 with the overall balance of payments shifting into a deficit. The credit markets still lack liquidity. The T-bill market developed slower than intended, mainly because the Ministry of Finance assessed the borrowing costs as unfairly high. As a consequence, the central bank was lacking an important tool for conducting monetary policy.

The larger than expected current account deficit in 1997 was more than fully covered by capital inflows. In particular, oil-related foreign investments were stronger than expected. While the oil price decline will negatively affect the current account balance in 1998, its impact on future foreign investments is probably negligible, as most investors in the oil business pursue a long-term strategy. The manat continued to appreciate in the first four months of 1998.

On structural reforms, all but one benchmark for end-March have been met. So far, the Azerbaijani parliament has failed to approve a new land code. As elsewhere, this proves to be a politically very sensitive issue. The restructuring of the four large banks brought mixed results. Two of them (International Bank and Savings Bank) made good progress and it is intended to sell them soon. The performance of the other two large banks was however poor.

The privatization of the small and medium-sized companies advanced well. However, the quality of the auction process has deteriorated. The restructuring and privatization of the largest companies is a very complex endeavor and more preparatory work is needed.

The growth and inflation targets of the program still look achievable. The decline in oil prices will however have a negative impact on both the current account and the budgetary revenues. However, my authorities have already taken measures to offset this impact. They reduced expenditures substantially in the beginning of the year. Moreover, higher excise taxes, the elimination of some tax exemptions, and stronger collection efforts have already been decided. Further measures to reduce the deficit by 0.75 percent of GDP are currently considered.

So far, the Achilles heel of Azerbaijan's reforms has been the only moderate speed of structural reforms. Many of these issues--privatization, land reform, banking sector restructuring, government employment reform--are very sensitive ones. Nevertheless, my authorities are willing to decisively go ahead with these reforms.

The medium-term outlook projections are highly uncertain, particularly in view of the large fluctuations of the oil price. The current scenario envisions a current account deficit of 3 percent in the year 2005. However, with oil-related foreign investment remaining strong, the overall balance of payments surplus will likely be large, allowing the central bank to build up international reserves and the government to accumulate a substantial amount of foreign assets. My authorities will have to decide in a timely manner where this money is deposited, who will manage its investment, and for what reasons part of that revenue is spent.

Last but not least, my authorities acknowledge the importance of timely and adequate statistical data. However, to cope with this demanding task, they will need further assistance from the Fund.

In sum, the macroeconomic picture in Azerbaijan remains impressive and steady gains have also been accomplished on structural issues. My authorities intend to continue with a prudent macroeconomic policy and push ahead structural reforms. To facilitate these endeavors, they request to purchase SDR 1.75 million under the extended arrangement and a disbursement of SDR 14.62 million under the second annual ESAF arrangement.

Let me conclude by thanking, on behalf of my authorities, the mission team, the resident representative, and the resident advisor for their fruitful cooperation with the Azerbaijani government and the central bank. My authorities are also grateful for the very valuable technical assistance received by the Fund.

Mr. Shaalan and Ms. Abdelati submitted the following statement:

Azerbaijan continues to reap the benefits of prudent macroeconomic policies, as evidenced by the virtual elimination of inflation and rapid acceleration of GDP growth (to 8.5 percent), in spite of recent oil price developments. The Azerbaijan authorities have in this way utilized the opportunity afforded by the oil wealth and made strides toward stabilizing the economy and building reserves. In order to preserve these gains, it is essential that progress on the structural reform agenda--which has so far been mixed--be accelerated and strengthened. Additionally, limited progress has been achieved since the last Board discussion with respect to improving budget transparency and expenditure control, finances of the four large state banks, and the general environment for private sector activity.

Like other oil producers, Azerbaijan is feeling the pinch of lower oil prices through a 22 percent shortfall in government revenues in the first quarter of 1998 and an expected 4 percent of GDP decline in export proceeds for the year. It is therefore heartening that the authorities are able to maintain their original deficit target of 3½ percent of GDP and have already undertaken measures to offset one-half of the expected decline in revenues (of 1½ percent) and are considering further measures depending on the revenue outcome for the first semester.

As noted by the staff, a number of governance issues have arisen in the past year which raise concern with respect to fiscal transparency and the environment for private sector activity. The report highlights the lack of transparent rules and control regarding the use of oil revenues, loss of government deposits from a commercial bank, conduct of privatization auctions that deviated from established procedures, lack of cooperation and unsatisfactory financial relations between the Ministry of Finance and the central bank, and heavy-handed investigations and excessive criminal penalties for economic crimes. We are encouraged by the priority given to these governance issues by the authorities, as evidenced by the measures outlined in Boxes 3 and 4 which signal appropriate government response, and we hope that these efforts will translate into tangible results in the near term. However, on the subject of corruption, the staff needs to exercise caution. More than anecdotal evidence is required to establish malpractice.

While further steps have been taken to develop a competitive financial sector and a strong banking system, we are particularly concerned and rather surprised that an important issue was relegated to a footnote, namely, that one third of banks are not in compliance with prudential regulations. This issue deserves greater prominence in the report and it calls for stricter enforcement of supervision principles. We hope the appointment of a resident technical advisor will facilitate and accelerate progress on this front. We also note that real interbank interest rates remain very high at over 20 percent and point to weak financial intermediation. We therefore welcome the planned measures intended to substantially deepen the treasury bill market and to liberalize financial markets through both opening of credit auctions to foreign-owned banks and privatization of two of the four state banks in the next twelve months. In the context of the third annual arrangement, we hope to see more concrete steps regarding the privatization and restructuring of the four state banks and agreement on how to proceed with the Agroprombank.

The high level of unemployment (20 percent) and high share of the population living under the poverty threshold (62 percent) is very worrisome. The staff indicates that the economic revival has produced little impact so far on the living conditions of the poor. A country endowed with the oil resources and experiencing rapid growth, like Azerbaijan, is better placed than most to tackle such problems. While we welcome the mission's recognition of this issue and the authorities' intention to improve means-tested targeting, it would be more reassuring to hear from the staff the intended outcomes of the measures identified so far. How much improvement, in terms of a reduction in poverty and unemployment, is expected from these measures and by when? Clearly, unless this is accorded the highest priority, support for the reform process could weaken substantially.

Finally, we support the proposed decision and we hope the discussion for the third annual arrangement will focus on the issues we have raised.

Mr. Vernikov made the following statement:

Azerbaijan's recent economic performance has been quite satisfactory. The authorities' compliance with all the performance criteria and indicators is commendable, and they have run their economic policy successfully. The economy enjoys a unique combination of low inflation and strong economic growth, although growth was lower because the initial drop in output in Azerbaijan was considerable, and there was a disruption caused by the civil conflict.

The authorities have been applying a reliable and responsible fiscal policy.

The relations between the government and the national bank of Azerbaijan are worrisome. The staff characterized the relationship as unsatisfactory, and neither institution pays interest rates on each others' deposit. This is definitely an irregular situation, which could have strong distorting effects on financial markets if these develop.

The stability of the manat is reassuring. In retrospect, allowing the manat to appreciate in nominal terms was the right decision because it allowed for a credible anchor for monetary policy, and enhanced the credibility of the authorities. While wages have increased in Azerbaijan, their current level does not appear to threaten the competitiveness of the country.

The magnitudes of the current account deficit are disconcerting. While it is being financed by strong inflows of capital, it is risky to maintain this situation, because the oil market may change rapidly. Hardly anybody had anticipated such a sharp and continued fall in oil prices, and many of the investment projects in Azerbaijan were considering a totally different price for oil. I wonder whether at some point there may be a revision of investment plans. If that is the case, the current account deficit on the order of 30 percent of GDP may turn out to be disruptive.

Some of the structural reforms could have been carried out with stronger impetus, especially on the privatization side, and in the banking sector. Two out of the four main state-owned banks are in bad shape. About one third of the banks are not in compliance with prudential regulations and have incurred a variety of administrative and financial penalties. The authorities need to take into account the lessons from other emerging market economies, and realize that they should address weaknesses in the banking sector as soon as possible, especially since their fiscal situation now is favorable, and there is much interest from foreign investors.

I support the proposed draft decision and wish the Azerbaijani authorities continued success in their reform efforts.

Mr. Al-Turki made the following statement:

Azerbaijan macroeconomic performance was impressive last year, with low inflation and strong growth. Sound financial policies, reflected in satisfaction of all performance criteria and prior action requirements, have paid off. However, it is regrettable that improvement in the standard of living was limited and unemployment rate remained high.

I broadly agree with staff appraisal, and will highlight a few points for emphasis.

First, given the economy's high dependence on oil, the authorities are strongly encouraged to improve further the non oil sector, including from oil-based industries. I am sure that the working group on the management of oil resources will take this issue into consideration.

On the budgetary front, it is encouraging that the authorities have taken measures in response to lower oil prices. The focus on reducing expenditures as well as increasing excise taxes is welcome. The revised program that envisaged a deficit equivalent to 3 percent of GDP shows proper flexibility in the program. Here, let me turn to a specific point. In the context of extra budgetary purchase, the report notes (on page 24, second paragraph) that "no institutional mechanism was in place to control the use of oil revenues." Could the staff elaborate on this.

Second, on the monetary side, improved cooperation between the financial institutions is crucial. The authorities's recognition of the poor relationship between the main financial institutions is a first step to solve the problem that contributed to slow improvements in the financial market.

Here, let me also note that the money multiplier declined instead of increased as envisaged in the program. Staff notes that persistent structural problems in the banking sector may cause the multiplier downfall. Could staff elaborate on that reversal.

Third, structural reform in agricultural sector needs to be accelerated. In this regard, it is unfortunate that production of the cotton industry was expected to decline this year after it had been privatized. Staff comments will be appreciated.

Finally, I welcome the authorities' decision to accept the obligations of Article VIII in the next few months.

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

Mr. Yao made the following statement:

I would like to join other Directors in commending the Azerbaijan authorities for the progress achieved in the adjustment process, which has led to the remarkable turnaround in economic growth and inflation. Noteworthy was the fact that the recovery in economic activity was fairly broad-based, despite the heavy dependence of the economy on oil resources. Notwithstanding these positive achievements, the recent decline in oil prices will adversely impact external current account and the budget deficit. This underscores the vulnerability of the Azerbaijan's economy to oil price changes. Therefore, it will be very important for the authorities to maintain the thrust of their efforts, so as to maintain macroeconomic stability and to strengthen structural reforms, especially in the areas of privatization and banking reforms, so as to ensure sustained high economic growth.

Overall, I am in broad agreement with the staff's analysis and policy recommendations, and I can support the proposed decision. I would like to make some comments on three issues.

The first issue is related to the composition of the Working Group on the management of oil resources. With the significant increase in financial resources expected from oil exports in the near future, it is important that the authorities follow prudent policies, so as to avoid the Dutch disease. I welcome the authorities' decision to establish such a Working Group. I encourage the authorities to clearly follow the guidelines to enhance the effectiveness of the Working Group. Here, I am referring to Box 4, points 1 and 2. Even though the composition seems to be broad-based, I note the absence of the civil society. Could the staff comment on the reasons of this absence?

The second issue is related to the sustainability of a broad-based economic growth in the medium-term. This, Mr. Chairman, will require a sound banking system and strong small- and medium- sized enterprises. In that regard, it is important that the authorities accelerate their efforts to reform the banking system, and take steps toward the privatization of the state-owned banks. Regarding the small- and medium-sized enterprises, I wonder if the authorities are presently examining policies that would foster their development. I note that the EBRD is providing assistance in that area in other countries in the region.

Finally, the third issue concerns governance. Unless quickly addressed, poor governance can affect the proper implementation of the program, and also the growth prospects of the country. I, therefore, encourage the authorities to take the steps outlined in Box 3 of the staff paper. For instance, reform of the legal and judicial system as well as of the civil service are important first steps in making the system more transparent. Similarly, the establishment of independent regulatory bodies and the creation of modern institutions can help. I welcome the staff intention to focus on governance issues during the discussions for the third year ESAF arrangement. However, I will appreciate it if the staff could provide some additional information on the following points: when did the fraud involving the loss of manat 100 billion of the government deposits take place? When did the staff find out that there was a fraud? And finally, what type of conditionality does the staff intend to require from the authorities in the context of the program?

With these remarks, I wish the authorities well in their future endeavors.

Mrs. Guti agreed with Mr. Yao that improved governance was important in the Azerbaijan Republic. The plan to look at conditionality on governance during the third year of the ESAF arrangement was justifiable, and that approach should also be applied to other countries in the same situation.

The staff representative from the European II Department agreed that more than just anecdotal evidence was required to establish the existence of corruption. The staff report referred to anecdotal evidence of corruption, partly because such evidence was widespread, and was suggestive of a rather general problem. Nonetheless, the staff report also pointed to four specific concerns about governance. While not all of them involved corruption, some of them did. The authorities shared the staff's concerns about corruption, as well as other governance problems. Fraud had also been discovered toward the end of last year and a detailed investigation of the ministry of finance had been undertaken.

The staff's intention with respect to conditionality in the third-year program was to introduce some specific structural benchmarks. While it was too early to say exactly what those benchmarks would be, they would likely deal with issues such as the drafting and the passage of the civil service law, the proposed restructuring of the administration, the passage of the civil code, and a further strengthening of the treasury system.

Mr. Yao wanted to know if the staff intended to require the government to cover the money that was taken fraudulently from bank accounts.

The staff representative from the European II Department noted that that was not a requirement under the program, and the investigation had not yet revealed the precise source of the fraud. The government was therefore not in a position to cover the money taken fraudulently from bank accounts.

Currently, control over the use of oil revenues was held narrowly by the presidency, the staff representative noted. The authorities' plans to establish a working group that would determine who had control over oil revenues, with broad representation across the government, including representatives from the central bank and from the oil sector, represented a substantial broadening of the debate on that issue. The authorities would likely be reluctant to go further at this stage to include members of the civil society. Nevertheless, the membership of the group had not yet been established and finalized, and the staff could convey to the authorities the suggestion that the representation could be broadened.

There was a lack of an institutional mechanism to control the use of oil revenues, the staff representative noted. The oil bonuses were paid into an account in the national bank that was under the control of the presidency, and decisions about the spending of the money were not taken in the context of the general budgetary discussions. Nonetheless, the use of this money had by and large been handled quite well. A large amount of it was being saved. Only a portion of it has been released for financing of the general budget, in line with understandings reached under the Fund program. The aim of the working group would be to establish more formal arrangements, including a formal link to the budgetary process, so that the use of the money in the future would be subject to open political debate.

A third of banks were not fully in compliance with prudential regulations, the staff representative noted. The national bank was taking quite strong actions against noncompliant banks. It had closed 13 banks in 1997 and a further 10 in the first quarter of 1998. In addition, the national bank had imposed sanctions against 14 banks in the first quarter. The letter of intent indicated that the national bank was committed, to strengthening its enforcement, and it had requested a long-term resident advisor. Such a person had been identified, and the staff hoped that he would take up a one-year assignment at the beginning of September 1998. That would make a major contribution to strengthening regulatory enforcement.

The fall in the money multiplier reflected the general weakness in the banking system, in particular, that less progress had been made early in the year than the staff had hoped, which had discouraged deposits. The fraud investigation, which involved police investigation of bank accounts, might also have led to some withdrawal of deposits. The Fund-supported program assumed a reversal of this trend in the money multiplier through the rest of the year, which was based on the view that the measures in place and the improved performance of some of the state banks should begin to strengthen confidence in the banking system. The government had also stopped a policy of directly debiting bank accounts for tax payments of enterprises, which should encourage enterprises to use the banking system more than they had in the past.

The fall in output in the cotton sector following privatization was surprising, the staff representative noted. A possible explanation was that the cotton processors had been purchased by a single foreign investor that tried to use its position to reduce payments to cotton farmers. As a result, some of the farmers switched to alternative crops, and cotton exports would likely fall this year. While that was certainly a cause for concern, the privatization of the cotton sector should, in time, lead to some recovery.

The European Bank for Reconstruction and Development was currently negotiating a credit to the government to foster the development of small- and medium-sized enterprises, the staff representative noted. A $10 million credit was expected to be concluded in Baku to support lending to small- and medium-sized enterprises. The credit was relatively small. The bigger problem that the enterprises would be facing was the weakness of the domestic banking system and the difficulty of borrowing from banks.

The size of the current account deficit was alarming, the staff representative considered. The potential sensitivity of the economy to large oil price fluctuations was highlighted in the staff report. The staff had had extensive discussions with the oil companies and detected no suggestion that, at current levels, there was any likelihood of a scaling back of investment over the next few years. The medium-term projections, even after taking into account the adjustments made as a result of lower oil prices, showed that the balance of payments was comfortably financed. But, as stressed in the report, there was a need for the government to develop more flexible policies to the exchange rate and to fiscal policy, in order to meet the potential risks associated with oil price volatility.

While the oil wealth in the Azerbaijan Republic would eventually translate into substantial revenues, those revenues were currently quite modest and the government had to tackle the poverty problems with limited resources, the staff representative noted. Although growth was strong, that did not seem likely to translate into a substantial reduction in unemployment, given the required restructuring of the old industries and the reductions in employment in the government sector. The authorities were trying to do the best they could with limited resources by targeting benefits through means testing. The impact of sustained growth in the non-oil economy could nevertheless be substantial, in particular in the services and agricultural sectors. The staff had stressed the importance of structural reforms in those sectors to ensure that the growth was sustained.

Ms. Abdelati agreed with the staff representative that not all of the governance issues regarding governance that were mentioned in the staff report were based on anecdotal evidence. With respect to the noncompliance of prudential regulations by the banks, could the staff clarify whether the noncompliance was due to the severity of the regulations, or whether the problem was widespread.

Mr. Vernikov noted that the sharp fluctuations of oil prices did not appear to have affected the staff's calculations, and wondered why investment decisions in the oil sector were so price insensitive. The staff report also indicated that the impact of lower oil prices on the current account would be partly offset this year by higher oil production and lower imports. However, in an international context, major oil exporting countries coordinated the amount of oil production they could supply. Had the staff taken that aspect into account, and how sustainable was the strategy of trying to offset the drop in oil prices by increasing its supply?

The staff representative from the European II Department agreed with Mr. Vernikov that investments in the oil sector would be sensitive in the long-run to a sustained reduction in the oil price. The investment program for the next few years in the Azerbaijan Republic was based principally on one large field where substantial investment had already been made and the oil potential was great. That type of investment would likely not be affected significantly by oil price fluctuations. More speculative investments and exploration activities could certainly be affected, especially if the oil price remained low in the long run. The Azerbaijan Republic's production was negligible in world terms, which allowed the Azerbaijan Republic to raise oil production in response to the fall in oil prices.

Some of the violations of the prudential regulations were serious, which had led to banks being closed, while other infractions were less serious and involved imposition of fines or restrictions on the banks' activities, the staff representative noted.

Mrs. Paris made the following statement:

> The continuation of strong macroeconomic policies, exemplified by vigorous growth, the absence of inflationary pressures, and a tight fiscal policy

is a notable achievement for which the authorities deserve praise. Beyond this performance, however, it should be recalled that the essential purpose of this program is to make progress in the area of structural reforms. A greater effectiveness could have been expected in this area.

The Azerbaijan Republic's economy is endowed with substantial oil wealth, but to reap the full benefit from the oil sector it is important to address the challenges on the structural reform front. Delays in restructuring the four troubled public banks, lagging progress on the reform of the agricultural sector, and evidence of a lack of governance are regrettable. The absence of adequate financial intermediation in the Azerbaijan Republic is a matter of substantial concern. In this respect, I support the staff's call for pushing ahead with the restructuring of the four state-owned banks and the privatization of the international and savings banks. Placing these privatizations as structural benchmarks under the third-year program would be welcome.

Foreign banks in the domestic market have so far played a limited role, but once the proper legal framework is in place there might be further scope for foreign banks to operate. It would be important to remove any restrictions that could limit the presence of foreign banks. Furthermore, the staff rightly stresses the importance of improving relations between the central bank and the ministry of finance, and the treasury bill market should play a more active role in the Azerbaijan Republic.

The lack of transparency in the privatization process and in the use of government oil revenue needs to be addressed. In this regard, I welcome the assurances provided by the authorities, and agree that this should represent a conditionality under the third-year ESAF program.

The impact of the oil price decline on the economy of the Azerbaijan Republic is notable, as evidenced by the staff assessment. The authorities' readiness to undertake several measures to offset the shortfall in revenues and to keep the deficit target unchanged is praiseworthy. Before considering further measures it would be necessary to assess the first semester outcome. More broadly, however, the vulnerability of two oil price violations makes a strong case for the need to reflect on the optimal use of future oil revenue. In this respect, I welcome the constitution of a special working group.

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

Mr. Rigász made the following statement:

The Azerbaijan Republic's determined pursuit of prudent macroeconomic policies has significantly improved its economic prospects. The impressive stabilization and subsequent substantial strengthening of domestic and external confidence must now be quickly followed with accelerated structural reforms aimed at eliminating structural weaknesses inherited from the former regime or resulting from the new economic realities.

This will make it possible to create a durable foundation for balanced economic growth.

The two most important medium-term challenges facing the Azerbaijan Republic have their roots in the country's substantial oil wealth. First, the expectation of significant oil revenues in the future threatens to encourage inefficiency and waste in the present. Care must be taken to use oil resources wisely. The temptation to relax fiscal discipline must be avoided at all costs. The experience of other oil producing countries shows that this is easier said than done, but the urgent need for major infrastructure projects at the present stage of development leaves the Azerbaijan Republic no room for mistakes. The government will have to plan its social spending carefully from the beginning of the oil boom in order to keep public expectations under control. It is understandable that in a country where 60 percent of the population lives below the poverty line, pressures to increase social spending will inevitably grow and will have to be addressed sooner or later. It is essential to strike an appropriate balance between investing in social and economic infrastructure and financing basic needs for the poor. We therefore applaud the government's decision to establish a working group to make recommendations about the optimal use of future oil revenues and to make use of the Fund's and World Bank's experience and expertise as inputs to its deliberations.

Second, the government must also resist the natural tendency to let the economy become too oil dependent. The background paper on recent economic developments notes that oil exports will account for 85 percent of the Azerbaijan Republic's total exports by 2005, while the oil export will contribute more than 50 percent of total budgetary revenues by that time. Depending on oil to this extent is bound to greatly increase the Azerbaijan Republic's vulnerability to external shocks. The chapter on vulnerability contains illustrative scenarios which show that the impact of oil prices changes on the Azerbaijan Republic's external position and budget will be substantial. Although the national oil reserves fund can provide a temporary fix for this problem, the only lasting solution will be a robust nonoil sector. The government will therefore need to start proceeding vigorously to implement its structural agenda in order to reduce existing rigidities and create an environment conducive to private sector investment and economic diversification.

With these remarks, I support the proposed decisions and wish the authorities all the best.

Ms. Lu made the following statement:

The Azerbaijan Republic authorities have made a great leap forward in terms of economic growth, price and currency stability, and international reserves. The accomplishments over the past three years in economic stabilization are credible and deserve high commendation. Tighter than programmed fiscal policies has served the Azerbaijan Republic well. In the context of a lower oil price, continued tight fiscal policy is necessary. As the staff report stated, both the Azerbaijan Republic's current account and fiscal revenue have been significantly affected by the reduction in oil price. However, since the authorities have taken prompt steps in revenue collections and expenditure cuts, the direct impact of a lower oil price in the Azerbaijan Republic's fiscal revenue was minimized. Even though these prompt measures reflected the authorities' initiative and determination in program implementation, some expenditures were unnecessarily squeezed by the insufficient issuance of treasury bills. Therefore, treasury bill issues need to be enlarged, which will benefit domestic financing of the fiscal deficit and improve the efficiency of monetary policy. On the other hand, fiscal governance, particularly expenditure control and the use of government oil revenue, has to be improved.

More efforts are required to accelerate financial sector reform, and the authorities should strengthen prudential regulations and supervision in the banking system. They should also explore financial markets, improve monetary policy and strengthen the financial intermediation and public confidence in the financial system. The underdeveloped financial market has impaired the effectiveness of monetary policy and the mobilization of resources for growth in the nonoil sector in the Azerbaijan Republic. The relationship between the central bank and ministry of finance needs to be improved to promote financial market developments and bank restructuring, especially in developing more diversified monetary policy instruments, to enable the central bank to sterilize its foreign exchange operations and conduct monetary policy more efficiently.

With the above remarks, I support the proposed decision and wish the authorities every success in the future.

Ms. Mercusa made the following statement:

The performance of the Azerbaijan Republic economy in the past year was in many respects better than envisaged under the program, and seems to indicate that the country is on its way to a robust recovery of output growth and financial stability. Results on inflation, GDP growth, and the fiscal area were better than expected, and the authorities deserve full credit for their determined actions.

In the structural area, the pace of reforms remains slow, in particular regarding the developments of a sound financial sector and a dynamic private sector. In the financial sector, the auditing of the four state-owned banks delivered only partial results, as two of the banks revealed worse than expected conditions, and there are still no clear plans on how to proceed. Priority should be given to restructuring the assets and management of banks, with recapitalization to be considered as a second step. The liquidation of the Agroprombank seems unavoidable at this stage, as its activity of lending to the agricultural sector has been taken over by other, more efficient financial institutions.

Although the privatization process of small to medium enterprises is at an advanced stage with respect to other CIS economies, it did not always deliver the expected results in terms of transparency and efficiency. In the cotton industry, the lack of transparency is due to the persistence of monopoly power. As the staff points out, the quality of the privatization auctions has deteriorated. The highly volatile fluctuation of the price of vouchers used for the auctions does not correspond to the supply and demand conditions at the auctions. The authorities may want to re-examine the allocation method used to sell public enterprises.

The oil sector has enormous importance in the Azerbaijan Republic economy. On the one hand, it is responsible for the persistence of a large current account deficit almost entirely attributable to foreign direct investment in oil plants and fields. On the other hand, it represents a source of future growth to the economy. The risk of a natural resource dependency and of the vulnerability of a single commodity economy are not to be overlooked. Furthermore, the trend in oil prices could place some more risk in future projects and investments. Diversification of economic activity is probably the only way to reduce vulnerability to external shocks.

Finally, could the staff comment on whether the process of admission to the WTO is proceeding smoothly.

With these remarks, we support the proposed decision.

Ms. Budington made the following statement:

As other speakers have noted, the Azerbaijan Republic authorities' continued discipline in macroeconomic management has set in place the foundations for high growth with low inflation and supported the investor confidence critical to the Azerbaijan Republic's ability to exploit its tremendous oil wealth. The medium-term prospects for the Azerbaijan Republic's economy are excellent, but depend upon proper management of these resources. Bearing this in mind, a key challenge for the Azerbaijan Republic will be to take advantage of the current window of opportunity to advance needed structural reforms before oil revenues come on line early in the next decade. I would note three points in this regard.

First, I was pleased to see the importance both the authorities and the staff place on the need for governance reforms—to address a number of problems that have been identified and to ensure that the benefits of oil are spread to all sector's of its economy and across its population, and not dissipated through inefficient use or corruption. Box 3 highlights the need for a wide range of reforms—including institutional improvements, judicial reforms and greater transparency to address these issues. At the same time, the authorities' action must demonstrate that good governance is a priority—the use of oil bonuses for the purchase of an aircraft outside normal budgetary procedures was particularly troubling in this regard. We also share the staff's concerns regarding the need for early clarification of the rights and limits of police and state prosecutors in the investigation of private enterprises and for reevaluation of new criminal penalties for economic crimes to ensure that they do not stifle legitimate enterprise.

Second, I was also pleased to note the establishment of a working group on the management of oil resources, with the welcome inclusion of the World Bank and IMF resident representatives. I wonder if the staff have any additional information regarding the timing and framework for the group's work.

Third, resolving the problem of the state-owned banks and developing the infrastructure to support a strong private banking sector remain critical challenges. In terms of the state-owned banks—the authorities' decision to move forward with the privatization of International Bank and Savings Bank are important steps in the right direction. In the case of Prominvestbank, I wonder if staff could provide an update on the current negotiations for a twinning arrangement. Finally, the authorities decision not to liquidate Agroprombank is difficult to understand—given the description in Box 1 of the current situation. I wonder if the staff could provide some information regarding the basis for this decision and what next steps are contemplated.

The background report also identifies the importance of current efforts to strengthen and deepen the Azerbaijan Republic's weak private financial sector. The government has taken some important steps, including strengthening prudential regulations and the recent passage of securities legislation. But continued efforts will be needed to support the effectiveness and the credibility of these efforts—including follow through on plans to establish a more active treasury bill market and to improve payment systems and a more ambitious time frame for removal of restrictions on foreign owned banks which can inject needed capital and expertise in this sector.

Finally, we concur with the proposed decision.

Mr. Phan made the following statement:

From the outset, this chair would like to support the staff's recommendation for the completion of the program review on the basis of the achievements obtained by the Azerbaijan Republic in its macroeconomic performance. As noted by the staff, the Azerbaijan Republic authorities have continued to pursue very strong macroeconomic policies and, by early 1998, achieved a rare combination of annual inflation close to zero and annual GDP growth rate of 8.5 percent. In the meantime, considerably increased foreign investments in construction and services have contributed in the non-oil economy together with a larger-than-expected increase in oil extraction and refined oil output.

The authorities are urged to closely monitor domestic monetary conditions, given the overall deficit on the balance of payments in the first quarter of 1998 while the fall in world oil prices and shortfalls in World Bank project loans are not expected to be overcome any time soon. Proper attention should be paid to addressing persistent structural problems in the banking system if the authorities are to ensure the increasing money multiplier as envisaged under the program. Increased participation in the T-bill and ANB auctioned loans markets should be encouraged.

The authorities are commended for implementing a tight fiscal policy as an important part of macroeconomic stabilization and recovery in the Azerbaijan Republic. Revenue performance has been promoted due to improvements in tax administration. The actions taken in this area in 1997 included the creation of a large tax payers unit, the strengthening of the State Tax Inspectorate, and improvements in tax administration of excise taxes for alcohol and tobacco. Further improvements in tax administration are needed if the authorities are to maintain satisfactory revenue performance in the coming time. The establishment of regional treasuries, the consolidation of government operations into a single treasury account and the closure of all manat bank accounts of budgetary institutions in public expenditure management in 1997 are highly welcomed, since these improvements could improve expenditure control and reduce the risk of mismanagement of government funds.

Turning to structural reforms, the authorities are commended for meeting all the program structural benchmarks for end-December 1997. However, enormous efforts are needed to accelerate the reform of the financial sector and private sector development if the authorities are to sustain macroeconomic growth over the medium term. As pointed above, the banking system has undergone persistent structural problems. The authorities are urged to overcome such weaknesses in the banking sector as liquidity problems, mismatches between funding costs and returns on lending, and large amount of bad loans. In addition, further efforts should be exerted without delay to overcome payment system bottlenecks in key areas in domestic currency transactions and in the foreign exchange market. Against this background, financial deepening will make it possible for the authorities to achieve the goal of using indirect instruments of monetary policy. Furthermore, supervision should be improved to allow for the building of a sound banking system.

With these remarks, I wish the authorities every success.

Mr. Yakusha made the following statement:

The authorities are to be commended for the impressive implementation of the program. We broadly share the views of the staff in the staff appraisal, and we support the proposed decision.

We share the concerns expressed by other Directors on governance issues, including the unregulated relations between the central bank and the ministry of finance. We also note that social indicators have not yet improved as one would expect, given the impressive economic growth.

We support the authorities on the issue of the pace of development of the T-bills market. The fiscal position of the government may not require the rapid development of the T-bills market. The effect of the open market operations is going to be limited anyway, given the scale of the foreign exchange inflows into the economy, while high real interest rates may send wrong signals to markets and worsen the prospects for the meaningful restructuring of the banking sector. At some point, the Fund should take a closer look at whether the advice to rapidly develop T-bills markets for a number of transition economies was entirely appropriate. While securitization of the government debt is generally a positive development, it might have failed in some cases to warn countries of overdevelopment of the T-bills market and the associated risks of volatility of short-term capital flows.

The representative from the European II Department noted that the preparations for the Azerbaijan Republic's accession to the WTO were proceeding well, but they were still at an early stage. The initial documentation for accession had been prepared and submitted.

The authorities' reluctance to liquidate Agroprombank was due to political reasons, the staff representative noted. The authorities believed that the bank had the potential to fulfill a valuable role in terms of countryside and agricultural lending. They were also encouraged by the success in turning around the position of the Savings Bank. The staff and the World Bank were actively involved in discussions on Agroprombank and recommended its liquidation. The important issue was that the staff and the authorities had agreed that the Agroprombank would cease to operate as a bank, which would limit the risk of any further damage to the budgetary position.

Mr. Vernikov noted that in many transition economies, banks were distributed unequally between the cities and the countryside. Capitals were usually overbanked, while the countryside lacked financial institutions. In the case of the Azerbaijan Republic, Agroprombank was the bank of the countryside, and it would be difficult to replace it. It would therefore not be a good idea to liquidate Agroprombank.

Ms. Budington wondered why management changes that had occurred in other banks had not been contemplated in the case of Agroprombank. There were also strong restrictions on the presence of foreign banks in the Azerbaijan Republic. The expertise needed in the banking sector could be provided if some of those restrictions were reduced.

The staff representative from the European II Department noted that the staff had pressed strongly for management changes in Agroprombank, but that had not yet happened. The situation, however, had deteriorated to a point that, even with management change, the bank could not be revived. Nevertheless, there was still a chance of separating the bank into two institutions, one as a debt-collection agency, and another as a small and potentially viable bank.

Only about 12 of Agroprom bank's branches in the country lacked a competitor, the staff representative considered. Savings Bank could actually provide the types of services required in the countryside, in most cases.

The staff had been pressing the authorities to remove the restrictions on foreign participation in the banking system, the staff representative noted. Recently, there had been significant progress, with the admission of foreign banks to participate in the treasury bill market. However, it was uncertain whether that was particularly relevant to the resolution of the problems of state banks.

Mr. Cippà made the following concluding statement:

At the outset, let me thank the Board for supporting the Azerbaijan Republic's request to make a further purchase under the combined ESAF and extended arrangement. I would also like to thank Directors for their interest shown for the Azerbaijan Republic economy and for their constructive comments. As usual, I will transmit to my authorities your comments and advice.

Mr. Owen has answered comprehensively all the questions that were raised, so that I can be brief. As noted by several Directors, the Azerbaijan Republic has continued to show a strong macroeconomic performance. Particularly positive was their swift reaction to revenue shortfalls earlier this year. On exchange rate policy, they continued to concentrate on smoothing fluctuations. Although the exchange rate has continued to appreciate, my authorities do not think that competitiveness is at risk.

My authorities are well aware that in the future the main task will be to speed up structural reforms. They made some good progress on banking restructuring. They will go ahead and sell two of the four major banks to the public very soon. They also intend to be strict toward low performers in the banking sector. More difficult will be the restructuring of large manufacturers. For quite many of them the prospects are not favorable, as their machinery is outdated, and they lack financing to modernize their production. However, much headway has been accomplished as regards the privatization of small and medium-scaled enterprises.

My authorities share the concerns raised by several of you about the frequent emergence of fraud and corruption. That is why they have put in place more severe rules and procedures to fight economic crime. However, the enhanced power given to law enforcement bodies seems to have created problems of its own. As the new rules are quite flexible, they have the tendency to make life for all business people harsher, and not only for the ones involved in dubious affairs. My authorities are well aware that there is a positive correlation between good governance and a steady, reliable flow of foreign and domestic investment. Therefore, they will put much emphasis on improving governance in all areas of the economy. Their objective is to open financial markets, to strengthen revenue and expenditure management, to make the public sector more accountable, and to increase transparency in the privatization process. They know that these endeavors will not be an easy task. However, it is already a good sign that problems as regards governance are discussed quite frankly in the Azerbaijan Republic. In many respects, that is a major improvement compared with other countries suffering from the some problem, but not willing to discuss it openly.

On the relationship between the Central Bank and Ministry of Finance, I fully agree that it should be normalized to avoid the very negative signaling to the market that Mr. Vernikov was indicating.

Let me conclude by once again expressing the gratitude of my authorities toward management and staff for the assistance and support provided to the Azerbaijan Republic.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for their success in achieving macroeconomic stabilization under the economic reform program supported by the ESAF and extended arrangements. In particular, they welcomed the fact that firm macroeconomic policies had succeeded in bringing annual inflation close to zero, while strong economic revival was under way. Directors noted, however, that the progress on structural reform had been mixed, and significant differences remained as regards the performance of the various sectors of the economy. They urged the authorities to accelerate the pace of reform efforts, in order to meet the severe challenges that the Azerbaijan Republic continues to face, particularly with regard to reducing high unemployment and poverty and developing the non-oil sector.

Directors supported the authorities' intention to maintain strict macroeconomic policies despite the impact of the recent decline in oil prices on government revenues. They welcomed the revenue measures already taken to partially offset the impact of lower oil prices, and some Directors encouraged the authorities to give further consideration to contingency measures for ensuring the achievement of the deficit target. Directors urged the authorities, however, to avoid across-the-board expenditure compression, which would weaken the budgetary process.

Directors supported the authorities' approach to exchange rate policy, which sought to smooth the short-term fluctuations and prevent excessive nominal appreciation, as large capital inflows linked to oil developments placed upward pressure on the manat. To strengthen the effectiveness of monetary policy, especially in sterilizing foreign exchange operations, Directors encouraged the authorities to move rapidly to develop the credit and treasury bills markets.

Directors commended the authorities for implementing important structural reforms, which had advanced the transition toward a market economy. However, they stressed the need to complement the gains in macroeconomic stabilization with an intensification of the structural reform efforts, including in the agricultural sector, to ensure that the recovery is broadly based and sustainable and to improve the climate for private sector activity. Directors regretted the limited progress to date in restructuring government expenditures and in strengthening expenditure control. They stressed that such reforms were essential to ensure the medium-term sustainability of the fiscal position.

While noting the steps being taken to develop a strong and competitive financial system, Directors stressed that restructuring of the banking sector was a priority task. Delays in solving the problems of four state-owned banks could hamper private sector development, particularly the small- and medium-sized enterprises, and threaten the recovery of the non-oil economy. Thus it was essential that the privatization of both the International Bank and the Savings Bank be completed according to schedule, and that quick and firm actions be taken to address the problems of the other two state-owned banks. Close cooperation between the central bank and ministry of finance was seen as essential to ensure success in these efforts. Noting that one-third of banks were not in compliance with prudential regulations, Directors stressed the importance of stricter enforcement and improved banking supervision.

Directors welcomed the authorities' plan to tackle governance issues forcefully and to improve fiscal transparency. They stressed that this had to be accomplished through a strengthening of the legal framework along market-oriented lines, improved financial control and accountability in the public sector, increased transparency in the privatization process, and, more generally, a reduction in the scope of government intervention in the economy. They commended the authorities' intention to overhaul the government's administrative structure, so as to improve the efficiency and effectiveness of public services, and urged them to complete the preparatory work quickly and move forward with the implementation of administrative reform in the 1999 budget.

Directors supported the authorities' policy of saving part of the oil-signature bonuses resulting from production-sharing agreements with foreign oil investors, and welcomed the establishment of a working group to make early plans for the optimal use of future oil revenues. They encouraged the authorities to establish an institutional mechanism that would preserve wealth for future generations, but stressed that any such mechanism should make fully transparent the use of the funds.

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

The Executive Board took the following decisions:

**Enhanced Structural Adjustment Facility—Review Under Second Annual Arrangement**

1. The Azerbaijan Republic has consulted with the Fund in accordance with paragraph 2(e) of the second annual arrangement under the Enhanced Structural Adjustment Facility for the Azerbaijan Republic (EBS/97/229, Sup. 1), the third paragraph of the letter dated December 8, 1997 from the Prime Minister, the Minister of Finance of the Azerbaijan Republic, and the Governor of the Azerbaijan Republic National Bank, and paragraph 43 of the memorandum of economic policies for 1997–98 ("memorandum") attached to the letter dated December 8, 1997.

2. The letter dated June 11, 1998 from the Prime Minister, the Minister of Finance of the Azerbaijan Republic, and the Governor of the Azerbaijan Republic National Bank shall be attached to the second annual arrangement under the Enhanced Structural Adjustment Facility, and the letter dated December 8, 1997 from the Prime Minister, the Minister of Finance of the Azerbaijan Republic, and the Governor of the Azerbaijan Republic National

Bank, with its annexed memorandum, shall be read as supplemented and modified by the letter dated June 11, 1998.

3. Accordingly, the indicators referred to in paragraph 3(a) of the second annual arrangement for the Azerbaijan Republic under the Enhanced Structural Adjustment Facility shall be as specified in Table 1 of the letter dated June 11, 1998.

4. The Fund decides that the midterm review contemplated in paragraph 2(e) of the second annual arrangement under the Enhanced Structural Adjustment Facility for the Azerbaijan Republic, the third paragraph of the letter dated December 8, 1997, and paragraph 43 of the memorandum attached thereto, has been completed and that the Azerbaijan Republic may request disbursement of the second loan specified in paragraph 1(a)(ii) of the same arrangement. (EBS/98/99, 6/12/98)

Decision No. 11749-(98/69), adopted
June 26, 1998

**Review Under Extended Arrangement**

1. The Azerbaijan Republic has consulted with the Fund in accordance with paragraph 3(d) of the Extended Arrangement for the Azerbaijan Republic (EBS/96/188, Supplement 2, 12/24/96) as amended, the second paragraph of the letter dated December 6, 1996 from the Prime Minister and the Minister of Finance of the Azerbaijan Republic and the Governor of the Azerbaijan Republic National Bank as modified, and paragraph 56 of the memorandum of economic policies for 1996–97 ("memorandum") attached to the letter dated December 6, 1996, as modified.

2. The letter dated June 11, 1998 from the Prime Minister, the Minister of Finance of the Azerbaijan Republic, and the Governor of the Azerbaijan Republic National Bank shall be attached to the Extended Arrangement for the Azerbaijan Republic as amended, and the letter dated December 6, 1996 from the Prime Minister, the Minister of Finance of the Azerbaijan Republic, and the Governor of the Azerbaijan Republic National Bank, with its annexed memorandum, as modified, shall be read as supplemented and modified by the letter dated June 11, 1998.

3. Accordingly, the performance criteria set out in paragraph 3(a) of the Extended Arrangement, as amended, for June 30, September 30, and December 31, 1998 shall be as specified in Table 1 to the letter dated June 11, 1998.

4. The Fund decides that the third review contemplated in paragraph 3(d) of the Extended Arrangement for the Azerbaijan Republic as amended, the second paragraph of the letter dated December 6, 1996 as modified, and paragraph 56 of the memorandum attached thereto as modified,

has been completed, and that the Azerbaijan Republic may continue to make purchases under the Extended Arrangement. (EBS/98/99, 6/12/98).

Decision No. 11750 -(98/69), adopted
June 26, 1998

## 3. KYRGYZ REPUBLIC—ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the Kyrgyz Republic's request for arrangements under the Enhanced Structural Adjustment Facility (ESAF) (EBS/98/95, 6/10/98; and Sup. 1, 6/12/98). They also had before them a policy framework paper for the period 1998–2000 (EBD/98/56, 6/9/98).

Mr. Cippá and Mr. Abdychev submitted the following statement:

Our Kyrgyz authorities are in broad agreement with the staff's analysis and appraisal presented in the staff report. They also express their profound appreciation to the staff of the Fund and the World Bank for their assistance in the preparation of the Policy Framework Paper.

Economic developments have been favorable in the past years, supported by a first three-year ESAF arrangement that was successfully concluded last March. Now the authorities request a new ESAF arrangement that will open a new phase in the market transition of the Kyrgyz economy. After stabilizing the economy, the Kyrgyz authorities are focusing on a second generation of reforms, aiming at sustainable, non inflationary economic growth.

Economic growth resumed in 1996 and continued throughout 1997 and the first half of 1998. In 1997 the inflation rate was around 15 percent, compared with 96 percent in 1994. The fiscal deficit was reduced significantly from 17.3 percent of GDP in 1995 to 9.4 percent in 1997. It was mainly achieved through a reduction in consumer subsidies, transfers, and net lending to the state enterprises, a modernization of the tax system, and a reform of budgetary procedures and intergovernmental relations. The authorities have cut down the level of the budget deficit's domestic financing from 8.2 percent of GDP in 1995 to 1.2 percent of GDP in 1997. Starting from 1998, the government is no longer entitled to borrow directly from the National Bank of the Kyrgyz Republic.

The government has substantially improved the budgetary procedures and regulations. With the support of the IMF resident advisor the authorities successfully established a treasury system which is now fully operational. The new law on budget principles has been adopted. Expenditure is carefully controlled under a system of expenditure warrants, the public investment program integrated into a consolidated budget, audit systems are being strengthened, and the new system of public procurement is in place.

The tight fiscal policy was supplemented by the restrictive monetary and credit policies that helped contain inflationary pressures and contributed to macroeconomic stabilization. The interest rate was reduced and the exchange rate stabilized. The National Bank has strengthened and diversified its monetary policy instruments.

Considerable progress has been achieved in the area of structural reforms. The government has initiated the reorganization and privatization of the largest enterprises in the energy, transport, industrial, mining, and telecommunication sectors. In parallel, the government is enhancing legislation to strengthen the corporate governance in joint-stock companies. Through comprehensive reforms the authorities have enabled long-term private leasehold of land and privatized most of the state and collective farms ensuring equitable distribution of land and property among the farmers. As a result of financial sector reforms, the public confidence in the financial institutions is improving. The amount of deposits is rapidly increasing as well as their share in the broad money. Efforts are also underway to create an effective legal and regulatory framework for the development of non-bank financial institutions, including a securities market. Energy tariffs continue to be adjusted to come closer to adequate cost recovery. Judicial reforms remain at the forefront of the government's strife to improve the rule of law.

The medium-term economic strategy that will be pursued under the new ESAF arrangement remains broadly unchanged from the one during the previous ESAF period. The government will continue to follow tight fiscal and monetary policies to maintain macroeconomic stability, and move ahead in structural reforms to ensure sustainable growth.

To expedite the recovery of the Kyrgyz economy, the main challenge is to lock in the gains already made. The government is paying particular attention to strengthening the private sector. For private sector growth, priority is given to agriculture and the revitalization of agroindustry given the fact that a large part of the population depends on agriculture. Emphasis is also placed on improving the regulatory environment for business, in order to foster growth and boost job creation. The authorities also realize that without growth there will be no meaningful reduction in poverty.

At the last Board discussion on the Kyrgyz Republic, Directors paid particular attention to the deterioration of the social indicators. The authorities understand the critical nature of this issue. Social policy aimed at poverty alleviation is a major priority of the new government. In this context the authorities will focus their efforts on improving the social safety net, including measures to strengthen the pension system, and reforms in the health and education systems. President Akayev has launched a wide-ranging National Poverty Alleviation Program, "Araket." This program seeks to provide employment generation, improved access to social services, more market-oriented labor legislation and pension reform. In fact, the chief architect of this program was appointed to the position of Prime Minister in the last March cabinet reshuffle. With regards to education and health care, the government is committed to keep the budget spending for these sectors at least constant in real terms. At the same time, these expenditures will grow in relation to total budgetary spending over the program period.

In the area of pension reform the authorities already made steps to improve the financial position of the social fund. A few days ago Parliament adopted amendments into the pension legislation raising the retirement age by six months every year over the next six years. Eventually, the current retirement age of 60 for men and 55 for women will be raised up to 63 and 58, respectively. Among other amendments is the reduction of the pension by 50 percent for working pensioners. These measures are the first within the overall pension system reform that will be supported by the World Bank and the Asian Development Bank.

The authorities pay particular attention to the external debt. They recognize the sensitivity of this issue for the economic stability of the country. However, it should be noted that during the first years of transition the external financing has been mostly on concessional terms for general budget support purposes. Now it is gradually switching to finance the growing public investment program, therefore, contributing to the economic growth. PIP accounts for about 60 percent of the total external financing. Nevertheless, the government will pursue a cautious external borrowing policy and will limit itself mostly to the concessional borrowing. The government is also taking measures to strengthen the external debt management within the Ministry of Finance and the cooperation with the National Bank in this area.

Our authorities reiterate their appreciation to the management and staff of the Fund, as well as other multilateral and bilateral donors for the valuable and timely assistance received thus far. They recognize that this assistance is playing a crucial role in the process of reform. They also look forward to the continuing support in the future.

Mr. Zakharchenkov made the following statement:

In the past, the Kyrgyz authorities have made significant progress towards building up a market economy and addressing structural imbalances. These achievements are clearly identified in the staff paper, and, on previous occasions, we have already given our compliments to the authorities. In our view, the new program addresses the key issues and is based on reasonable targets. Although the country's overall economic situation remains difficult, I believe that the program has a good chance for success. In light of the successful completion of the first ESAF, and the authorities' strong commitment to undertaking further reform efforts, this chair has no difficulty in supporting the proposed decision. While we are in broad agreement with the thrust of the staff appraisal, I would like to limit myself to providing several comments on the most important issues.

The Kyrgyz economy experienced a significant real sector growth of at least 6.5 percent in 1997, which might be understated by the official statistics. Nearly one third of it was due to the recovery of agricultural production, while the start-up of operations of the Kumtor gold mine also played a significant role. It is true that this growth was partially attributable to favorable weather conditions. However, I would not say that it was driven primarily by one-time factors, as the growth in agriculture was underpinned by structural measures including the comprehensive land reform. But I agree with the staff that the support from the private sector was not as strong as had been anticipated.

Monetary policy remains appropriate as it succeeded to reduce inflation and interest rates as well as to resist recent pressures on the national currency. In this area, we would like to underscore the importance to develop monetary policy instruments and to eliminate the outdated system of foreign exchange auctions. While commending the Kyrgyz authorities for progress in addressing financial market problems and in improving the supervisory capacity of the NBKR, I would like to note that the country's financial system is still weak and the authorities should stand ready to take additional steps in tightening monetary policies, if necessary, and if appropriate.

Fiscal policies have been adequately tight over past years, and it is expected that they will strengthen under the proposed program. We welcome the authorities' commitment to further improve revenue collection and to contain expenditures. On the revenue side, we urge the authorities to resist parliamentary pressures to reduce the land tax rate. On the expenditure side, creation of the treasury and the budget committee will eventually contribute to improving control over public expenditures. Finally, I noted in the staff paper that the informal sector of the Kyrgyz economy has increased over past years. In this connection, I wonder if there are any estimates on the extent of such increase, and if some steps are envisaged to reverse this situation.

In the external sector, the program allows for some deterioration of the overall balance of payments, which is related mainly to the debt amortization payments on the Kumtor project. I would not be cautious on that issue, as the deficit is expected to be fully financed in 1998/99 by the international financial agencies. External competitiveness has been preserved with average wages well below those of neighboring countries. Finally, a high reliance on one export commodity is not the case in the Kyrgyz Republic, as indicated in para 44 of the paper, and the program projects a further diversification of exports. Therefore, I would consider the proposed external policies to be appropriate.

One of the weakest aspects of the Kyrgyz economy is the rapid accumulation of external debt, which increased from virtually nil to 55 percent of GDP in recent years. Moreover, it is projected that the debt-to-GDP ratio will continue to increase up to the year 2000. Therefore, it is a worrisome development even if the bulk of it was on concessional terms. In this connection, we welcome the authorities' commitment to pursue a cautious borrowing policy and to limit nonconcessional borrowing as well as to strengthen the debt managing capacity of the Ministry of Finance. Cleaning up the existing arrears is also commendable. Altogether, we share the staff view that the current debt situation seems to be sustainable in the medium term and is under the authorities' control. On the positive side, I would like to refer to Messrs. Cippà's and Abdychev's Buff which indicates that external borrowing is now being switched to finance the public investment program, thereby contributing to economic growth. Finally on that issue, I wonder weather it is correct to exclude the Kumtor debt service payments in the calculation of the debt service ratio (Table 1 on page 42 of the staff paper).

On the structural side the program rightly emphasizes the importance of private sector expansion. The renewal of the privatization process, particularly of the large public monopolies, and the continual strengthening of the legal basis will also contribute to developments in this area. It is commendable that the authorities intend finally to address the issue of the overgenerous pension system, which has become an impediment for public savings growth. As indicated in the Buff statement some of the steps have already been undertaken. Finally, with respect to the design of the program, it properly addresses the issues of deterioration in such areas as health and education, which is hard to over-estimate for the success of the future economic growth.

In conclusion, I would like to reiterate our support of the proposed decision. With these remarks we wish the Kyrgyz authorities continued success in their endeavors.

Mr. Hinata made the following statement:

The Kyrgyz Republic implemented its economic reform program supported by the ESAF arrangement broadly satisfactorily and, as a result, attained significant stabilization of the economy with positive growth since 1996, coupled with subdued inflation. The authorities are now requesting a new ESAF-supported program to consolidate the favorable outcome of the first ESAF program and to make the economic foundation more solid. Having seen the contents of the new program and the commitment of the authorities to the implementation of reform that they showed us in the first program, I have no difficulty in supporting their request.

I broadly agree with the thrust of the staff appraisal as to what the authorities should vigorously pursue under the program. But I would like to offer a few comments, for emphasis.

First, on the external imbalance, while the authorities have succeeded in reducing the external imbalance through reform efforts thus far, and even maintained a positive overall balance in recent years, they should not lessen their efforts in improving the external position. I certainly see a welcome reduction in trade deficit in recent years. But the persistent existence of deficit in the services account, and a rapid decrease in capital inflows as the Kumtor mine-related capital flows taper off, will leave the economy externally weak. Thus, a cautious policy stance with a tightening up of financial policy will continue to be very important. On the fiscal front, the authorities have prepared a variety of specific measures to enhance revenue and reduce expenditures. These measures should be carried out boldly. Here, I have to express my concern that delayed progress in the pension system has been and will remain a factor working against the fiscal consolidation effort. The authorities have shown us immediate and future measures to improve the pension system in their Letter of Intent and their Policy Framework Paper respectively, including the introduction of a taxpayer identification number. These measures are welcome and I hope the authorities will make every effort to implement them.

Still, on external weakness, I totally share the staff's concern about the rapid pace of the increase in the external debt. I welcome the authorities intention to apply strict limits on nonconsessional borrowing and to improve external debt management.

Second, let me touch upon the structural side. Recent economic growth has been supported mainly by favorable developments in agricultural production and the progress in the Kumtor Gold project. I am certainly aware that the production base of the Kyrgyz economy has been broadened as a result of the reform effort. But further effort in this regard is necessary. To this end, the authorities should step up efforts to promote these activities by establishing a more market-oriented economic system. I, therefore, urge the authorities to press ahead with structural reform, in particular, in the areas of privatization, agricultural reform, and legal and institutional reform.

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

Mr. Al-Turki made the following statement:

I commend the Kyrgyz authorities for their commitment to the ESAF-supported program. Over the past three years their efforts to transform the economy have been paying off. Growth has accelerated, inflation has decelerated, the fiscal position has strengthened, and a number of important structural reforms have been implemented. However, it is clear that more is needed to transform the economy and place it on a sustainable growth path. I endorse the authorities' request for a new ESAF-supported program as it will provide the appropriate framework to build on the progress already achieved.

Reducing the Kyrgyz Republic's dependency on external finances is a priority. The sharp rise in external debt over the past years has increased the vulnerability of the economy. That debt may be financing nonviable activities is all the more worrisome. It is therefore critical for the authorities to strengthen debt monitoring capabilities and to refrain from contracting additional nonconcessional external debt. Achieving this objective depends in part on enhancing domestic savings. In this regard, I endorse the emphasis on fiscal consolidation, and welcome the recent measures to strengthen the 1998 fiscal stance. The better than expected tax collection in the first quarter of this year is reassuring. It is essential, however, not to undermine this performance by reducing the land tax at this stage. On the expenditure side, the ongoing efforts in cooperation with the World Bank to reform the pension system are steps in the right direction.

Enhancing domestic savings also depends on a sound and efficient banking system. In this regard, it is encouraging that the banking system is not experiencing difficulties, and is meeting the NBKR's prudential requirements. However, I agree with the NBKR on the need to carefully monitor the activities of commercial banks, especially in view of the recent surge in credit, and the sharp expansion in external debt.

The central priority on structural reforms is to advance the privatization program. In that connection, completing the planned divestiture of remaining state enterprises on schedule would constitute a major step. The authorities' emphasis on streamlining laws and regulation is also welcome.

Mr. Fernandez made the following statement:

The Kyrgyz authorities have made significant progress during their first ESAF-supported program, and I support the proposed arrangement, which is well-balanced and puts fiscal consolidation on the forefront. It is nevertheless clear that the authorities' dedication to reform is a prerequisite to achieving the program's objectives, given the many challenges facing the country.

First, money and exchange markets are sensitive to movements affecting Russian financial markets, and require vigilance on the part of the authorities.

Second, the Kyrgyz Republic has a small internal market, industrial activity remains weak, and the agricultural production is highly dependent on climatic conditions, which may not always be as favorable as in 1997. Third, the debt burden is a threat to the economy and calls for a prudent approach.

Finally, the new impetus on the privatization program is welcome, but requires strong policy determination to succeed. Special caution is also warranted in the financial sector, where banking supervision has to be under close control at a time when the number of banks operating in the country is expected to rise in the period ahead.

With these comments, I support the proposed decision, and wish the Kyrgyz authorities success in their endeavors.

Ms. Pinzani made the following statement:

The authorities have made commendable progress under the first ESAF arrangement. The second three-year ESAF arrangement aims to consolidate these results. The program is based on an appropriate mix of demand and supply policies. We can support its approval.

While maintaining sound macroeconomic policies, the authorities should concentrate their efforts on implementing those measures which are aimed at inducing a supply response from the economy. It is, indeed, imperative to move toward a self-sustained growth path and to invert the declining trend in social indicators. In this regard, it is of paramount importance to remove the structural rigidities that are hampering the emergence of a strong private sector and to accelerate the process of trade liberalization.

We urge the authorities to fully implement the privatization of the large utility companies, to strengthen corporate governance in the privatized companies, to develop a comprehensive strategy for agriculture, and to reform the labor code and the judicial system. These elements will create an appropriate environment to attract foreign investment and boost domestic production.

Having said that, let me underline two gray areas in the proposed program, which deserve, in our view, closer attention.

In the fiscal area, we welcome the going into effect of a treasury system at the central government level. This is an important step toward effective expenditure controls. However, we are surprised to note that, while the staff recognized that some of the expenditure measures are not under direct government control, there is no reference either in the staff report or in the policy matrix regarding the need for reviewing and improving central and local government fiscal responsibilities. A review would also be important given the mixed result achieved last year with respect to tax collection and the central authorities' intention to improve the targeting of an ample range of social expenditures. Could the staff please comment on whether it considers the present system appropriate in order to achieve these objectives.

In the monetary area, we believe that an insufficient emphasis is placed on the need for strengthening the banking system which appears to be undercapitalized and not operating properly, even if it does not encounter difficulties in meeting the existing prudential regulation. Indeed, banks that avoid traditional lending to the public and prefer to invest in treasury bills are not performing their basic function of reallocating resources among market operators. This practice may undermine the development of a strong and active private sector. We urge the authorities to reconsider the timing of their intervention in the financial system and, for example, to begin from this year the gradual increase in the capital requirement.

With these remarks, we support the proposed decision.

Mr. Otazú made the following statement:

After several years of an extremely difficult transition to a market-based economy with significant costs in terms of output, employment and increased poverty, the Kyrgyz Republic has made substantial progress in macroeconomic stabilization in the context of the ESAF-supported program, which expired last March. As a result, GDP growth jumped to about 7 percent a year during the past two years and inflation came down from the hyper inflationary level of 1,259 percent in 1992, to 15 percent in 1997. However, the resumption of growth has not been sufficiently broad-based to avoid a further deterioration in the social indicators, despite the progress with disinflation in recent years. The successor ESAF arrangement should contribute to further consolidate gains on the stabilization front while advancing reforms in the structural area, including the strengthening of the safety net. Fiscal consolidation, monetary policy discipline and more rapid structural reforms should be part of the strategy to reduce and shortening the costs of transition. Since I am in broad agreement with the staff appraisal, I will limit my comments to a few points for emphasis.

Fiscal policy should be centered on improving the performance of customs, excise and VAT tax collection, as well as on other specific revenue-enhancing measures, such as the equalization of excise rates for domestic and imported goods at the higher level applied to imported goods, and the elimination of tax exemptions, which jeopardize the attainment of fiscal targets. Revenue will also benefit from measures to enhance the cooperation between the State Tax Inspectorate (STI) and State Customs Committee (SCC), and from the elimination of nonviable Free Economic Zones (FEZs). Structural reform loans from the World Bank and the ADB, intended to address some of these issues, should be carefully implemented. On the expenditure side, it is crucial to establish strict control procedures covering all categories of spending. I welcome the significant reduction of current expenditure as a percentage of GDP envisaged in the program, by further containing the wage bill, phasing out transfers and subsidies, and restraining purchases of other goods and services. This should allow some room for increasing social expenditures to secure an effective social safety net while maintaining in real terms spending on health and education.

On monetary policy I would underscore the importance of steadfastly avoiding inflationary credit creation and introducing indirect instruments of monetary policy. Monetary conditions have worsened recently as a result of the surge in bank credit. This situation shows the difficulty of the NBKR to contain monetary expansion within reasonable limits putting the inflation target at risk. In the medium term, this could adversely impact on the soundness of the banking system. Consequently, I agree with the staff on the need to carefully monitor the activities of commercial banks and to strengthen preventive banking supervision and to improve monetary policy by relying more on market-based indirect instruments. The liberalization of the external sector to which the authorities are committed on efficiency grounds should also serve to curb inflationary pressures.

On the structural front, I welcome the authorities' decision to privatize about 300 medium and large-scale enterprises during the program for 1998-2000 that includes the divestiture of large monopolies, such as the telephone, gas and energy companies, the national airline and utilities' enterprises, among others. Privatization of enterprises, provided that it is accompanied by management expertise and new technologies could produce significant efficiency gains for the economy. In this context, these divestitures should be accelerated. Similarly, a comprehensive public pension reform is needed not only because the current pension system has been a major drag on the budget during the first three-year ESAF arrangement, but also to as a means of deepening a domestic capital market. Reform of the civil service should also remain a priority. More generally a redefinition of the role of the state in the economy is crucial to create appropriate conditions for non-inflationary growth.

With these remarks, I support the proposed decision and wish the Kyrgyz authorities the best in their laudable efforts.

Mr. Hammoudi made the following statement:

Significant progress has been made by Kyrgyz authorities in implementing strong macroeconomic stabilization and adjustment reforms in the framework of the first ESAF arrangement. Real GDP growth has been substantial in 1996 and 1997 due to increased productivity in agriculture and manufacturing sectors. Inflation rate has been reduced well below the program target due to strict monetary and credit policies. The fiscal situation has improved significantly with lower deficit, and better planning, financing and execution of the budget. The current account deficit improved dramatically in 1997 from 23.5 percent of GDP in 1996 to 8.2 percent. On the structural front, we are pleased by the completion of the coupon privatization program and the initiatives taken in areas such as banking, legal and regulatory framework. Furthermore, reforms have been introduced in sectors such as agriculture, energy, water, mining. Consequently, we have no difficulty in supporting Kyrgyz's request for a new three-year arrangement under the ESAF. However, the external debt has increased sharply since the independence from nil to 55 percent of GDP in 1997 and the N.P.V. of public debt/exports ratio has attained 115 percent including foreign grants. On the social front, we are concerned about the high unemployment rate at around 20 percent in 1997, and poverty which has risen to 60 percent in 1996 compared to 40 percent in 1993.

The Kyrgyz authorities face some daunting challenges and substantial bilateral and multilateral assistance is essential to the success of the program. This being said, we agree with the staff that further adjustment efforts are needed to consolidate gains achieved in stabilizing the economy and speed up structural reforms. The authorities should continue implementing strict fiscal and monetary policies with the objective of bringing down inflation to single digits. In this respect, it is important to streamline expenditures as well as to improve the quality of spending, the tax administration and the credit allocation. However, we are of the view that social expenditures should increase especially within the framework of a strong social safety net to offset the negative impact of the reforms on the most vulnerable segment of the population.

Speeding structural reforms is essential to the broadening of the economic base since the agriculture—dependent on climatic conditions—accounts for almost half of GDP. Indeed, diversifying of the economy implies further progress in privatization. In this context, we are encouraged by the authorities' intention to implement a new program of divestiture. Furthermore, we are impressed by the number of reforms being initiated in areas such as: budget, pension, tax, banking, labor, governance, legal system and statistics. The objective is to introduce market instruments, efficiency and transparency in the economy. There is, however, a need for a substantial technical assistance from the international community, bilateral and multilateral sources, due to a lack of sufficient skilled human resources in the country for such an important agenda of reform.

In the external sector, the authorities would be well advised to adopt prudent policies with the objective of improving the debt situation. In this respect, we welcome the authorities' intention to favor the non-concessional borrowing in order not to erode further the external situation. Incentives to foreign direct investments and exports' diversification would help the authorities improve Kyrgyz's external position in the medium term.

With these remarks, we wish the authorities every success in their adjustment efforts.

The staff representative from the European II Department noted that the authorities were working closely with the World Bank and the Asian Development Bank to reform the pension system. The authorities had also taken some important steps to implement recommendations by the staff for improving the pension system. In particular, a decision had been made to increase the retirement age from 60 years to 63 years for men and from 55 to 58 for women, as well as to reduce the payments to working pensioners by about 50 percent. Those measures constituted savings of about 12 percent of the budgetary subsidy.

The central government control over expenditures had been strengthened considerably, the staff representative noted. A Cabinet budget commission would monitor those developments closely. While substantial progress had been made with respect to local governments, in particular under the World Bank-sponsored program, the authorities were aware that more progress was needed in controlling expenditures at the local level.

Customs performance and social spending needed to be improved, the staff representative noted. The consolidation of expenditures needed to be accompanied by improvement in the composition of expenditures, with particular emphasis on social sector expenditures.

The staff agreed with the central bank on its decision to improve the monitoring of commercial bank activities, in particular given the turmoil in the markets, the staff representative noted. The banking system in the Kyrgyz Republic had made significant progress in the past three years. A recent joint technical assistance report by the Basle Committee and the Monetary and Exchange Affairs Department gave the Kyrgyz Republic high marks on prudential regulations and on the progress made in the banking system. Improvements could, however, be made in the nonbank financial sector.

Both the debt service of the Kumtor gold mine and its exports were being excluded from the external sustainability calculation, because Kumtor was like an island of economic activity and the staff wanted to develop a better measure of the vulnerability of the economy to the external environment, the staff representative noted.

The official estimate of the private sector in the Kyrgyz Republic was 35 percent of GDP, although it could comprise up to 60 percent of GDP if the shadow economy was included, the staff representative considered.

The staff and the government agreed that the divestiture of state enterprises needed to be speeded up, the staff representative noted. Following the mass privatization program, the remaining enterprises were large and difficult to privatize, although four or five of the most important state monopolies had been placed under the privatization program. The government had announced recently a request for an international investment adviser to proceed as rapidly as possible toward the privatization of the telecommunications company.

The Kyrgyz Republic required substantial technical assistance, both on a multilateral basis and on a bilateral basis, the staff representative considered. Multilateral institutions and major countries had been providing substantial assistance. The administrative capacity of the country needed to improved to ensure the success of the successor ESAF.

Mr. Cippà made the following concluding statement:

> I would like to express the gratitude of my Kyrgyz authorities for the continuous support and advice that the Fund is providing to the country in its difficult, but quite successful, economic transition to a market economy. I also want to thank the Board for the insightful and constructive discussion we just had and for the most valuable comments and advice that I shall convey in full to Bishkek.
>
> The Kyrgyz Republic in many ways is rightly considered as a leader among transition economies. This country was among the first in the region to engage into a broad effort of economic transformation, supported in this by the Fund and the international community. Over the past few years, sound macroeconomic policies associated with a commendable reform effort led to significant progress and the results are beginning to materialize. As elaborated in more details in the excellent staff report, economic growth has resumed, and it is currently running around 6-7 percent, inflation is down and the som is a remarkably stable currency. Even on the structural front, some very important steps have been made, namely in the financial and budgetary field.
>
> However, my authorities are well aware that the recovery remains fragile, and that their task is far from over. They know that the private sector is not yet contributing the way it should to the general economy, and given the demographic trends they know that such a contribution is a must for this young country. They know that too many impediments and rigidities still hinder the free working of market forces. They know that so far they have relied heavily on external resources, and that this can become a problem in the future. And above all they observe the deterioration of the key social indicators, and they are strongly committed to put a stop to this unsustainable and socially unacceptable development.
>
> For all these reasons my authorities know that they cannot relax their effort toward reform at this point. That is why they are today requesting a new three-year ESAF arrangement, which should mark the post consolidation phase of the Kyrgyz economy and put it on a sound and sustainable economic growth path. As the staff qualifies it, the new ESAF program is ambitious, but my authorities strongly believe that they can make it, and of course I share Mr. Catsambas' plea for continuing the provision of technical assistance.

To conclude, let me reiterate the gratitude of my Kyrgyz authorities for all the support, financial and technical, that the international community in general and the Fund in particular has given to them in these past years. Special thanks go to Mr. Catsambas and his team, to the resident representative, and to the Managing Director who honored Kyrgyzstan with his visit in May on the occasion of the celebration of the fifth anniversary of the introduction of the Kyrgyz national currency.

The Executive Board took the following decision:

1. The government of the Kyrgyz Republic has requested a three-year arrangement under the Enhanced Structural Adjustment Facility and the first annual arrangement thereunder.

2. The Fund notes the policy framework paper for the Kyrgyz Republic set forth in EBD/98/56.

3. The Fund approves the arrangements set forth in EBS/98/95, Supplement 2.

Decision No. 11751-(98/69), adopted
June 26, 1998

## 4. MARSHALL ISLANDS—1998 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1998 Article IV consultation with the Marshall Islands (SM/98/136, 6/11/98; and Cor. 1, 6/19/98) and the compendium report describing country-specific developments against the background of common issues affecting the Marshall Islands and the Federated States of Micronesia (SM/98/134, 6/11/98). They also had before them a background paper on recent economic developments in the Marshall Islands (SM/98/144, 6/16/98).

Mrs. Gonzalez made the following statement:

My Marshall Islands authorities are in broad agreement with the thrust of the staff report. They recognize that the ultimate challenge in the period ahead is to successfully transform the economy from one that has been overly dependent on external financing to one that can generate enough resources to become more self-reliant. The primary constraints facing the country are well-known and include its relatively small size, geographical isolation, limited scope for diversification, and low factor endowments.

Faced with the prospect of the financing arrangements under the "Compact of Free Association" with the U.S. coming to an end in 2001, the authorities have been taking steps to strengthen the fiscal position while also moving to increase the role of the private sector in the economy. Assisted by a loan from the Asian Development Bank (AsDB), they began to implement a Policy Reform Program (PRP) in 1996 which included measures to downsize the government, reduce subsidies, raise revenue collections, and attract investments—especially foreign investments—mainly through improvements in the legal and regulatory framework. The establishment of a Private Sector Unit in the Office of the President will help in this effort.

My authorities agree with the staff that it has to front-load their adjustment efforts, particularly on the fiscal area, in order to address macroeconomic imbalances and structural problems. Fiscal adjustment would have to bear the bulk of the adjustment burden because of the very limited scope for independent monetary policy, given the use of the US dollar as the legal tender. The full implementation of the fiscal reform, however, has been hampered by the government's weak implementation capacity and the need to secure the provision of basic education and health services, which entails substantial costs in a widely dispersed archipelago such as the Marshall Islands. The latest information received indicates that the management crisis in Air Marshall Islands is being resolved. The number of government employees is also expected to be reduced by an additional 100 by the end of this month, failing which, other options, such as an across-the-board salary cut and a shortening of the work week, will be considered.

In the medium term, the authorities are committed to strengthening tax and customs administration and to removing the remaining tax and duty exemptions. They plan to introduce a VAT by early 1999 but this could be delayed because of the need to educate the business community and the public about this system. A performance-based budgeting system will also be introduced to further reduce and/or restructure government expenditures.

There is a need to redress the serious deficiencies in macroeconomic data. Improving the statistical information is important both for enhancing decision-making and policy formulation and for presentation to the international donor community and the international financial institutions. While faced with a lack of experienced personnel, my authorities intend to make every attempt to improve the provision of core statistics.

My authorities would like to place on record their appreciation to the Fund staff for the recent Article IV discussions. In view of their current predicament, they look forward to having regular contact with the Fund in between the 24-month consultation cycle. Where possible, it is recommended that the Fund considers joint missions with the AsDB and/or the World Bank, with the view to assisting in the development of a comprehensive and workable program of adjustment and reform.

Mr. Karunasena made the following statement:

The Marshall Islands economy, which has been in a transition period since 1996 changing from a high dependency on external grant assistance to become a more self-reliant economy, faces an extremely difficult adjustment period. External factors such as the Asian crisis and the strengthening of US dollar have further aggravated the difficulties faced by the Marshall Islands authorities. Improvement in macroeconomic stability and continuation of structural reforms are crucial to overcome these difficulties and turn around the contracting domestic production.

As I am in broad agreement with the staff for its analysis and recommendations, only the following few points will be highlighted for the emphasis.

The real GDP, which contracted sharply during the last two years, is further contracting in 1998. Given the necessity of sharp fiscal consolidation, the growth stimulus has to come from the private sector investment expansion and productivity growth through improving resource allocation efficiency. In this regard, we welcome the authorities' efforts to improve a conducive environment for the private sector investment expansion by reducing the public sector share in the economy, and continuing structural reforms. As the domestic private savings and investment could play a crucial role in this context, I would like to ask the staff whether it has any idea about domestic private savings and investment.

I agree with the staff that the major adjustment in the reform efforts has to come from the fiscal side. Even though the government expenditure has been declining in the recent past the improvement in the overall fiscal balance has been less pronounced as both the revenue and grants declined. In this context we are concerned about the large fiscal slippages in 1998 as reflected by the supplementary budget enacted in March 1998 amounting to additional 6 percent of GDP in government expenditure. Accordingly the fiscal adjustments on both fronts, i.e., expenditure reduction and revenue enhancement are crucial to improve the macroeconomic balances. With regard to the revenue efforts the introduction of the VAT is a crucial step in the right direction.

Given the limited role that monetary policy and exchange rate policy could play in macroeconomic management, due to the use of U.S. dollar as the domestic currency, the adjustments have to depend mainly on the fiscal side and structural reforms.

I wish the staff could explain whether there is any significant impact of the recent economic contraction on the quality of banks' portfolio as the domestic credit expanded sharply despite output declines. Similarly, I expect the staff may shed some light on the high interest spread, which is about 10 percent in the banking system.

With these comments, I wish the Marshall Islands authorities all success in their efforts.

Mr. Hammoudi made the following statement:

I would like to thank the staff for producing the compendium report that facilitates cross-country comparisons. Problems of both groups of islands are quite similar, except that Table 1 in the report, page 10, shows that the Marshall Islands appears to be worse off than Micronesia on the external front, with lower GDP per capita, higher external current account deficit, and higher external debt due. But on the fiscal front the Marshall Islands appear to be in better shape. I believe that part of the reason is that they have better control over their revenue earnings and expenditure patterns than the largely autonomous and more cumbersome administrative systems in the Federated States of Micronesia. The staff may wish to clarify our comment on this.

I welcome the authorities' intention to cut expenditures in the framework of prudent fiscal policy. I hope they can overcome the prevailing weak implementation capacity that is a common factor in many of the smaller member states of the Fund.

Technical assistance should be provided if the adjustment program is to be successfully implemented. One problem that comes to mind, and which is linked to the implementation capacity, is how can this micro state, with limited resources, improve its absorption of Fund-supported and/or other technical assistance—for example, the Asian Development Bank. Could the staff comment on this aspect.

I am concerned about the reduction of the staffing position mentioned in Mrs. Gonzalez's preliminary statement. Given the lack of administrative capacity, I am curious to know in which areas of the government they are being reduced. Are these reductions in the productive or nonproductive sector of the government? If the government is serious about reducing its size, it should encourage the private sector, which in turn could create jobs for the staff being deployed from the public sector, after appropriate retraining. In this regard, improving the regulatory environment is essential to stimulate foreign direct investment from the private sector.

Finally, I agree with the staff that an improvement in the compilation of statistical data is crucial. The benefits have been mentioned in Mrs. Gonzalez's opening statement. Without adequate statistical data, there is a potential risk of jeopardizing effective surveillance by the Fund and other international donors. In this context, the authorities should be provided with adequate technical assistance to overcome their difficulties in this field.

Ms. Budington made the following statement:

With the Chairman's permission, I, like my colleague, would like to comment jointly on the Marshall Islands and the Federated States of Micronesia, given the similarity in the challenges they are confronting. The staff has provided very useful and very concise reports in both cases, including the very welcome compendium. As I agree with its conclusions, I will be very brief.

Obviously, both countries face an enormous and, it should be emphasized, quite difficult transition as they prepare for the phasing-out of Compact of Free Association funding. The staff has emphasized and the authorities clearly understand that putting their fiscal position on a sustainable track and setting in place the reforms that will allow a reduction of the government's role in the economy are the two key pillars of necessary reforms. Full and timely implementation of the reforms highlighted in Box 2 of the compendium are essential to realization of these goals and to the prospects for future international funding.

I noted that, in terms of performance under AsDB programs to implement these reforms, the progress in Micronesia has been satisfactory, while there have been some delays in the provision of funding to the Marshall Islands. Obviously, while there have been a number of difficult steps taken in the Marshall Islands, there is a need to re-invigorate the effort to keep on track with this program, given the very short time that remains under the Compact.

In terms of the Fund's role, obviously there is a very important role in terms of technical assistance and in terms of policy advice. I share the concerns that have been expressed by others regarding the constraints that exist in implementation capacity in these economies, but I do agree with the staff that the technical assistance resources which the Fund does have are a scarce resource and need to be focused on countries that are willing to use them to the fullest extent possible. I hope that in both cases this will occur, given the obvious need for such assistance in both economies.

Finally, I have a few questions on some of the specific points made in the staff report. First, I wonder if the staff could provide more background on the decline in non-tax revenues. Second, the introduction of a value-added tax is mentioned as key to future prospects. I would appreciate a bit more detail from the staff on progress in preparations in both countries. I noted in Ms. Gonzalez's statement, in the case of the Marshall Islands at least, an indication that there may be some delays. Lastly, in the case of the Marshall Islands, I noted in the medium-term projections that the financial holdings are projected to remain quite low into the medium term. I am wondering if that is something that we should be a bit concerned about.

Mrs. Coronel made the following statement:

I would also like to say a few words on both the Marshall Islands and the Federated States of Micronesia, basically to acknowledge the reform efforts of the authorities to correct the public finances and external accounts, and to encourage them to keep the pace of adjustment. A prudent fiscal stance is a key need for both economies, given the prospective reduction in the grants under the Compact of Free Association, and might hopefully set the basis for further assistance by the U.S. and other foreign governments in the post-Compact period.

The process of structural reforms should also be strengthened and the regulatory environment improved, keeping in mind the objective of reducing the role of the government in the economy, encouraging foreign investment, and—in general—promoting private sector activity. Structural reforms should include further reductions in government employment, and action to remove obstacles affecting investment approvals, land use, and commercial contracts.

We attach much importance to the provision of technical assistance from the Fund to help the authorities improve implementation capacity, which might currently be an obstacle both to more rapid reform, and to the availability of adequate statistical data.

With these remarks, I wish the authorities of Marshall Islands and Micronesia luck and success in the future.

The staff representative from the Asia and Pacific Department, in response to questions raised by Executive Directors, made the following remarks:

Directors had some questions on the finances of the Marshall Islands and also perhaps Micronesia. There was a question on why nontax revenue had declined sharply for both Micronesia and Marshall Islands. This decline was mostly related to sales of passports, which granted citizenship to foreign nationals, that both Micronesia and Marshall Islands had undertaken in 1994/95. The staff understands that this program of sales ran into some problems with the United States authorities and therefore to curtailment in further sales of these passports, which accounts, basically, for the sharp fall in nontax revenues in both Micronesia and Marshall Islands.

On the introduction of the value-added tax, Marshall Islands is at a more advanced stage than Micronesia. The Marshall Islands government has presented to the parliament a series of legislation to put in place the value-added tax. The authorities explained that they were facing some resistance from the business sector who were afraid that it would affect negatively their activity. In the case of Micronesia, the four states are quite independent, and sales taxes are subject to the agreement of the congresses of each of the four states. The authorities expect that it will take some time before they are able to reach a consensus to have all the four states act as one to implement a value-added tax. They have asked for technical assistance in helping them do that.

Directors had questions on the banking sector, specifically if there were any negative effects on the portfolio of the banks. In the Marshall Islands, most of the nonperforming loans were actually the result of the government's liquidity problems. Because there is traditionally a system where all repayments of personal bank loans were linked to direct payments out of the salaries of the government workers, and the government at various periods could not transfer the monthly amounts to the banks, this has led to problems of nonperforming loans for the banks, in terms of their loans for individuals. Since then, the government has resolved this problem, and the banks' proportion of nonperforming loans is currently much lower than it had been in 1996/97. At the same time, from this negative experience, banks had also curtailed credit for personal purposes, and also reduced the maturity terms of these credits.

On Ms. Budington's question on the medium-term projections for the financial holdings in the Marshall Islands, the government has substantially run down most of its balances, and also it has borrowed against about 50–60 percent of its remaining compact grants. The staff thus does not expect that the Marshall Islands would be in a position to build up further its financial holdings. In fact, the authorities have announced a scheme whereby they would be requesting from donors financial resources to set up a trust fund similar to those that have been established in some of the other Pacific Island countries, like in Kiribati.

Directors had questions on the absorptive capacity of the governments of Marshall Islands and Micronesia for technical assistance. Clearly, with the reduction in the size of the governments, the mission raised a concern that, especially, in the area of statistics, personnel for collecting and disseminating statistics should be protected from downsizing. The downsizing affected all areas of government. In the Marshall Islands, the basic problems they had and the delays from the agreed timetable to reduce the size of the government, were basically in the health and education sectors, where the authorities were awaiting assistance from the Asian Development Bank to help define a plan to ensure that the health and the education services of the government of the Marshall Islands would not be too adversely affected by the downsizing.

Mr. Hammoudi asked whether the staff had an alternative scenario for the medium-term outlook, if, for example, the grants were lower than expected.

The staff representative from the Asia and Pacific Department responded that the matter had been discussed with the authorities, but they did not expect that the grants would disappear completely. Clearly, there was some uncertainty surrounding the continuation of the grants, and if they were to disappear completely, then the authorities would face a situation similar to that faced by Micronesia's Chuuk state, and they would have to shut down the government.

Mrs. Gonzalez made the following concluding statement:

If I may just add to what Mr. Lee already said in response to the questions. I think a question was raised about the reductions in government personnel in these countries. The information we got from the authorities is that at least 40 percent of the downsizing involved the administrative support staff. So this should not adversely affect in a very big way the provision of essential services.

On behalf of my FSM and Marshall Islands authorities, I would like to thank Directors for their interest and comments. The authorities value your comments and advice and I am confident that they will consider them in their efforts to achieve self-reliance. I would also like to thank the staff for its perseverance and hard work. We know that statistics are limited and I understand that there were only two staff members who went to the islands for the consultations. They deserve commendation for coming out with very concise but very clear reports. Our authorities, as we have already indicated, look forward to having regular consultations with the staff in between the 24-month cycle.

I think that in the case of these two microstates, which are undergoing transition, the support of the international community will be very important, in terms of both financial support, especially foreign direct investments, and technical assistance, and in the areas of skills training and institution building.

We would like to urge the potential providers of this support to be forthcoming in this regard. The authorities recognize that they need to establish a sound track record in order to merit this support, and they are trying their best to do that, within their limited capacities.

In the interests of greater transparency, my authorities have indicated their willingness to issue PINs on the results of the consultations.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the bold adjustment measures that had been put in place since FY1996 in preparation for the prospective elimination of grant assistance from the United States in 2001 under the Compact of Free Association. Directors considered the implementation of the reform measures essential for a resumption of sustained growth in the medium term.

Directors expressed serious concern about the slippage in fiscal policy in FY1998 and about the supplementary budget that had been enacted without the assurance of additional financing. They urged the authorities to take immediate actions to bring the adjustment program back on track. Directors noted that a sustained track record in the implementation of the reform measures would be key to securing additional support from the international financial community to ease the Marshall Islands' transition to a less dependent economy and to allow a resumption of financial support from the Asian Development Bank.

In the fiscal area, Directors recommended that the government intensify its efforts to downsize the public sector workforce and scale back outlays on goods and services and on subsidies, while maintaining adequate allocations for social sectors. Measures to broaden the tax base through removal of exemptions and to strengthen tax administration should be enacted without delay; additional measures should be considered, including the proposed introduction of a value-added tax. Directors recommended the provision of technical assistance in order to ensure the smooth implementation of the reform program.

Directors stressed the need to accelerate structural measures to promote private sector activity, including by legislation to facilitate foreign direct investment and clarify the use of land.

Directors called on the authorities to put greater emphasis on strengthening the Marshall Islands' economic and financial statistics. Better use of Fund technical assistance would allow the authorities to submit core data to the Fund on a regular and timely basis.

It is expected that the next Article IV consultation with the Marshall Islands will be held on the 24-month cycle. In the interim, Directors recommended more regular contact between the Fund staff and the authorities, including through Fund staff participation in Asian Development Bank and World Bank missions, if necessary.

## 5. FEDERATED STATES OF MICRONESIA—1998 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1998 Article IV consultation with the Federated States of Micronesia (SM/98/135, 6/11/98) and the compendium report describing country-specific developments against the background of common issues affecting the Federated States of Micronesia and the Marshall Islands (SM/98/134, 6/11/98). They also had before them a background paper on recent economic developments in the Federated States of Micronesia (SM/98/143, 6/16/98).

Mrs. Gonzalez made the following statement:

The next few years will be critical for the Federated States of Micronesia (FSM) as it attempts to reduce its dependence on external financing and strengthen its capacity for self-reliance. The challenge for the FSM authorities is to manage the transition in a structured and efficient manner at a time when real output has declined, its external competitiveness has deteriorated, and investor interest has fallen in the wake of the Asian crisis.

In anticipation of the possible reduction of the U.S. compact grants in 2001, and in recognition of the importance of generating large fiscal surpluses, the Public Sector Reform Program (PSRP) was initiated in 1996. Under this program (which enjoys broad public support), some progress has already been achieved in reducing expenditure both at the state and national levels, and in commercializing the operations of public enterprises. There have been some delays, however, in downsizing the government workforce in some states. The Chuuk state authorities plan to cut employment in the health and education sectors, but only if these cuts do not adversely affect the services provided in these areas. A study to assess the impact of manpower cuts is currently underway. The Pohnpei state authorities are facing a serious liquidity problem this year on account of legislative delays in finalizing further reductions in the workforce and in increasing various state taxes. Other states have made good progress in implementing fiscal measures, thus resulting in an improvement of their respective financial situations.

My FSM authorities have made some headway in raising tax revenue by switching the computation of import duties from f.o.b to c.i.f basis, and by removing exemptions and improving enforcement of tax laws. They are committed to doing more, e.g., the introduction of a broad-based tax such as a VAT, and the unification of state and national tax administration offices to improve tax collections. My authorities consider the introduction of a VAT a major undertaking and will need technical assistance in drafting the necessary VAT legislation and the implementing rules and regulations, as well as in coordinating the public information campaign.

Some progress has also been achieved in enhancing private sector participation in economic activity. The new investment law which will streamline investment approvals has been ratified by Kosrae state, and is expected to be ratified by the three other states shortly. The decline in real wages following a further downsizing of the government, and the continued freeze in government wages should help offset the losses in external competitiveness arising from the dollar appreciation. The liberalized trade environment is also supportive of private sector growth.

The authorities recognize that they have to address the shortcomings in FSM's statistical database. A number of proposals to reorganize the national and state statistical offices are being considered. An improved statistical organization should help facilitate prioritization and production of core statistical data, although the shortage in experienced manpower will remain an important constraint.

My authorities wish to thank the staff for the 1998 Article IV consultation. They are in broad agreement with the thrust of the staff appraisal and policy recommendations. In view of their precarious condition, they would welcome regular contact with the Fund staff in between the 24-month cycle. Where possible, joint missions with the AsDB and the World Bank could be considered by the Fund.

Mr. Hammoudi underlined that the authorities should develop the economy and improve the standard of living conditions in order to encourage the skilled human resources to remain, rather than emigrating to the United States.

Mr. Carlens made the following statement:

Mr. Chairman, you turned our attention to the fact that the staff has experimented with new forms of documentation for this discussion. We welcome that the staff does experiment with documentation for Article IV consultations.

This chair has often aired the view that comparisons and parallels with other countries should be used to a larger extent in reports.

At the same time, it is our impression that many earlier comments in the Board, including from this chair, on documentation in surveillance have focused on the importance of streamlining and shortening papers.

Although I appreciate the compendium paper in itself, I am therefore not quite sure whether we are moving in the right direction here, by adding a new type of document rather than improving or replacing the existing ones. Especially since, in my view, it does not seem to add too much in substance.

Mrs. Gonzalez pointed out that, given the fact that the compendium report prepared by the staff was an experiment, perhaps Directors could provide some guidance to the staff on whether such a report should be continued in the future. Also, Directors might wish to comment on her authorities' proposal for the staff to be more regularly engaged in consultations with the authorities, possibly through joint missions with the Asian Development Bank and/or the World Bank.

Ms. Budington remarked that the compendium staff report had been useful, as so many issues were common to the two countries and comparisons between the two countries' experiences were easier. Perhaps it would also be useful to follow Mr. Carlens' suggestion to consolidate the reports into one document, and perhaps to consolidate the discussions as well. In terms of increased consultations or staff participation of missions, the matter could be left to the discretion of management and the staff to determine whether there would be value in such contacts.

Mr. Hagan said that he agreed with Ms. Budington on the matter of the compendium staff report and the possibility of combining the two consultations. On the issue of joint missions with the World Bank or Asian Development Bank, perhaps the staff or the Acting Chairman could share their views with the Board. In principle, it should be encouraged, but there might be some practical or financial problems associated with the matter.

Mr. Hammoudi made the following statement:

> I would like to thank the staff for producing the compendium report that facilitates cross-country comparisons. Problems of both groups of islands are quite similar, except that Table 1 in the report, page 10, shows that the Marshall Islands appears to be worse off than Micronesia on the external front, with lower GDP per capita, higher external current account deficit, and higher external debt due. But on the fiscal front the Marshall Islands appear to be in better shape. I believe that part of the reason is that they have better control over their revenue earnings and expenditure patterns than the largely autonomous and more cumbersome administrative systems in the Federated States of Micronesia. The staff may wish to clarify our comment on this.
>
> I welcome the authorities' intention to cut expenditures in the framework of prudent fiscal policy. I hope they can overcome the prevailing weak implementation capacity that is a common factor in many of the smaller member states of the Fund.
>
> Technical assistance should be provided if the adjustment program is to be successfully implemented. One problem that comes to mind, and which is linked to the implementation capacity, is how can this micro state, with limited resources, improve its absorption of Fund-supported and/or other technical assistance—for example, the Asian Development Bank. Could the staff comment on this aspect.
>
> I am concerned about the reduction of the staffing position mentioned in Mrs. Gonzalez's preliminary statement. Given the lack of administrative capacity, I am curious to know in which areas of the government they are being reduced. Are these reductions in the productive or nonproductive sector of the government? If the government is serious about reducing its size, it should encourage the private sector, which in turn could create jobs for the staff being deployed from the public sector, after appropriate retraining. In this regard, improving the regulatory environment is essential to stimulate foreign direct investment from the private sector.

Finally, I agree with the staff that an improvement in the compilation of statistical data is crucial. The benefits have been mentioned in Mrs. Gonzalez's opening statement. Without adequate statistical data, there is a potential risk of jeopardizing effective surveillance by the Fund and other international donors. In this context, the authorities should be provided with adequate technical assistance to overcome their difficulties in this field.

Ms. Budington made the following statement:

With the Chairman's permission, I, like my colleague, would like to comment jointly on the Marshall Islands and the Federated States of Micronesia, given the similarity in the challenges they are confronting. The staff has provided very useful and very concise reports in both cases, including the very welcome compendium. As I agree with its conclusions, I will be very brief.

Obviously, both countries face an enormous and, it should be emphasized, quite difficult transition as they prepare for the phasing-out of Compact of Free Association funding. The staff has emphasized and the authorities clearly understand that putting their fiscal position on a sustainable track and setting in place the reforms that will allow a reduction of the government's role in the economy are the two key pillars of necessary reforms. Full and timely implementation of the reforms highlighted in Box 2 of the compendium are essential to realization of these goals and to the prospects for future international funding.

I noted that, in terms of performance under AsDB programs to implement these reforms, the progress in Micronesia has been satisfactory, while there have been some delays in the provision of funding to the Marshall Islands. Obviously, while there have been a number of difficult steps taken in the Marshall Islands, there is a need to re-invigorate the effort to keep on track with this program, given the very short time that remains under the Compact.

In terms of the Fund's role, obviously there is a very important role in terms of technical assistance and in terms of policy advice. I share the concerns that have been expressed by others regarding the constraints that exist in implementation capacity in these economies, but I do agree with the staff that the technical assistance resources which the Fund does have are a scarce resource and need to be focused on countries that are willing to use them to the fullest extent possible. I hope that in both cases this will occur, given the obvious need for such assistance in both economies.

Finally, I have a few questions on some of the specific points made in the staff report. First, I wonder if the staff could provide more background on the decline in non-tax revenues. Second, the introduction of a value-added tax is mentioned as key to future prospects. I would appreciate a bit more detail from the staff on progress in preparations in both countries. I noted in Ms. Gonzalez's statement, in the case of the Marshall Islands at least, an indication that there may be some delays. Lastly, in the case of the Marshall Islands, I noted in the medium-term projections that the financial holdings are projected to remain quite low into the medium term. I am wondering if that is something that we should be a bit concerned about.

Mrs. Coronel made the following statement:

I would also like to say a few words on both the Marshall Islands and the Federated States of Micronesia, basically to acknowledge the reform efforts of the authorities to correct the public finances and external accounts, and to encourage them to keep the pace of adjustment. A prudent fiscal stance is a key need for both economies, given the prospective reduction in the grants under the Compact of Free Association, and might hopefully set the basis for further assistance by the U.S. and other foreign governments in the post-Compact period.

The process of structural reforms should also be strengthened and the regulatory environment improved, keeping in mind the objective of reducing the role of the government in the economy, encouraging foreign investment, and—in general—promoting private sector activity. Structural reforms should include further reductions in government employment, and action to remove obstacles affecting investment approvals, land use, and commercial contracts.

We attach much importance to the provision of technical assistance from the Fund to help the authorities improve implementation capacity, which might currently be an obstacle both to more rapid reform, and to the availability of adequate statistical data.

With these remarks, I wish the authorities of Marshall Islands and Micronesia luck and success in the future.

The staff representative from the Asia and Pacific Department, in response to questions raised by Executive Directors, made the following remarks:

Directors had some questions on the finances of the Marshall Islands and also perhaps Micronesia. There was a question on why nontax revenue had declined sharply for both Micronesia and Marshall Islands. This decline was mostly related to sales of passports, which granted citizenship to foreign nationals, that both Micronesia and Marshall Islands had undertaken in 1994/95. The staff understands that this program of sales ran into some problems with the United States authorities and therefore to curtailment in further sales of these passports, which accounts, basically, for the sharp fall in nontax revenues in both Micronesia and Marshall Islands.

On the introduction of the value-added tax, Marshall Islands is at a more advanced stage than Micronesia. The Marshall Islands government has presented to the parliament a series of legislation to put in place the value-added tax. The authorities explained that they were facing some resistance from the business sector who were afraid that it would affect negatively their activity. In the case of Micronesia, the four states are quite independent, and sales taxes are subject to the agreement of the congresses of each of the four states. The authorities expect that it will take some time before they are able to reach a consensus to have all the four states act as one to implement a value-added tax. They have asked for technical assistance in helping them do that.

Directors had questions on the banking sector, specifically if there were any negative effects on the portfolio of the banks. In the Marshall Islands, most of the nonperforming loans were actually the result of the government's liquidity problems. Because there is traditionally a system where all repayments of personal bank loans were linked to direct payments out of the salaries of the government workers, and the government at various periods could not transfer the monthly amounts to the banks, this has led to problems of nonperforming loans for the banks, in terms of their loans for individuals. Since then, the government has resolved this problem, and the banks' proportion of nonperforming loans is currently much lower than it had been in 1996/97. At the same time, from this negative experience, banks had also curtailed credit for personal purposes, and also reduced the maturity terms of these credits.

On Ms. Budington's question on the medium-term projections for the financial holdings in the Marshall Islands, the government has substantially run down most of its balances, and also it has borrowed against about 50–60 percent of its remaining compact grants. The staff thus does not expect that the Marshall Islands would be in a position to build up further its financial holdings. In fact, the authorities have announced a scheme whereby they would be requesting from donors financial resources to set up a trust fund similar to those that have been established in some of the other Pacific Island countries, like in Kiribati.

Directors had questions on the absorptive capacity of the governments of Marshall Islands and Micronesia for technical assistance. Clearly, with the reduction in the size of the governments, the mission raised a concern that, especially, in the area of statistics, personnel for collecting and disseminating statistics should be protected from downsizing. The downsizing affected all areas of government. In the Marshall Islands, the basic problems they had and the delays from the agreed timetable to reduce the size of the government, were basically in the health and education sectors, where the authorities were awaiting assistance from the Asian Development Bank to help define a plan to ensure that the health and the education services of the government of the Marshall Islands would not be too adversely affected by the downsizing.

The Acting Chairman stated that, if there were a need for joint missions, then Fund staff could join missions led by other organizations. The matter would be judged on a case-by-case basis, with input from the Executive Director concerned. The compendium paper was useful, although care would be needed to ensure that such reports did not unduly add to the staff workload on surveillance activities.

Mrs. Gonzalez made the following concluding statement:

If I may just add to what Mr. Lee already said in response to the questions. I think a question was raised about the reductions in government personnel in these countries. The information we got from the authorities is that at least 40 percent of the downsizing involved the administrative support staff. So this should not adversely affect in a very big way the provision of essential services.

On behalf of my FSM and Marshall Islands authorities, I would like to thank Directors for their interest and comments. The authorities value your comments and advice and I am confident that they will consider them in their efforts to achieve self-reliance. I would also like to thank the staff for its perseverance and hard work. We know that statistics are limited and I understand that there were only two staff members who went to the islands for the consultations. They deserve commendation for coming out with very concise but very clear reports. Our authorities, as we have already indicated, look forward to having regular consultations with the staff in between the 24-month cycle.

I think that in the case of these two microstates, which are undergoing transition, the support of the international community will be very important, in terms of both financial support, especially foreign direct investments, and technical assistance, and in the areas of skills training and institution building. We would like to urge the potential providers of this support to be forthcoming in this regard. The authorities recognize that they need to establish a sound track record in order to merit this support, and they are trying their best to do that, within their limited capacities.

In the interests of greater transparency, my authorities have indicated their willingness to issue PINs on the results of the consultations.

The Acting Chairman then made the following summing up:

Executive Directors, taking note of the statements made by Mrs. Gonzalez, Ms. Budington, Mr. Hammoudi, Mr. Carlens, and Mr. Hagan, agreed with the thrust of the staff appraisal in the report for the 1998 Article IV consultation with the Federated States of Micronesia.

It is expected that the next Article IV consultation with the Federated States of Micronesia will be held on the 24-month cycle. In the interim, Directors recommended more regular contact between the Fund staff and the authorities, including through the Fund staff participation in Asian Development Bank and World Bank missions, if necessary.

## DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/98/68 (6/25/98) and EBM/98/69 (6/26/98).

### 6. DEMOCRATIC REPUBLIC OF THE CONGO—OVERDUE FINANCIAL OBLIGATIONS—REVIEW FOLLOWING SUSPENSION OF VOTING RIGHTS

Paragraph 4 of Decision No. 11686-(98/30), adopted March 18, 1998, shall be amended by substituting "by September 11, 1998" for "by June 29, 1998 or at the time of the next Article IV consultation with the Democratic Republic of the Congo, whichever is earlier." (EBS/98/109, 6/22/98)

Decision No.11752-(98/69), adopted
June 25, 1998

### 7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/98/116 (6/24/98) is approved.

APPROVAL: August 18, 1999

SHAILENDRA J. ANJARIA
Secretary