February 13, 2001
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 98/114

10:00 a.m., November 6, 1998

Contents

Executive Board Attendance

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

Executive Directors	Alternate Executive Directors
	S.M. Al-Turki
A. Barro Chambrier	A.R. Ismael, Temporary
T.A. Bernes	T. Turner-Huggins, Temporary
	J. Nelmes, Temporary
	W. Szczuka
	F. Zurbrügg, Temporary
	J. Schaad, Temporary
B. Esdar	O. Schmalzriedt, Temporary
N. Eyzaguirre	A.G. Zoccali
	J.A. Costa, Temporary
R. Faini	J. Spraos
J. Guzmán-Calafell	E. González-Sánchez, Temporary
K.A. Hansen	O.-P. Lehmussaari
	A.R. Palmason, Temporary
W. Kiekens	N. Goffinet, Temporary
K. Lissakers	M. Sobel, Temporary
	S.D. Melese d'Hospital, Temporary
	R. Fernandez
	N.R.F. Blancher, Temporary
	M. Daïri
	S. Rouai, Temporary
J.P. de Morais	C. Rustomjee
A.V. Mozhin	A. Lushin
S. Pickford	H. Hagan, Temporary
	H. Mori, Temporary
	D. Chen, Temporary
	M.H. Elhage
M.R. Sivaraman	N. Jadhav, Temporary
	O. Kwon
J. de Beaufort Wijnholds	E.J.P. Houtman, Temporary
	A. Kapteijn, Temporary
	H. Ono
	H. Ogushi, Temporary
	D. Fujii, Temporary
	C. Harinowo
	Nguyen Q.T., Temporary
	R. Djaafara, Temporary
	Qi J., Temporary
	Wang X., Temporary

A. Linde, Acting Secretary
A. Mountford, Acting Secretary
N.M. Hairfield, Assistant
P.J. Kunzel, Assistant
S. Soromenho-Ramos, Assistant

Also Present

IBRD: F. Cazenave, South Asia Regional Office; S. Gooptu, Europe and Central Asia Regional Office; J.A. Katz, F. Kilby, and O.A. Meesook, Africa Regional Office; R.K. Peters and A.G. Zeijlon, Europe and Central Asia Regional Office. African Department: A. Basu, Deputy Director; G.E. Gondwe, Deputy Director; P.A. Acquah, J. Chai, K. Christou, D.G. Cowen, G.Z. El-Masry, J. Fajgenbaum, E.C. Harris, R.D. Kibuka, P. Neuhaus, A. Tahari. Asia and Pacific Department: H. Neiss, Director; S. Nolan, M.R. Stone. European II Department: J.R. Marquez-Ruarte, Deputy Director; O. Havrylyshyn, A. Richter, J.A. Schiff, K.A.-M. Westin. External Relations Department: S.J. Anjaria, Director; W. Murray. Fiscal Affairs Department: C.A. Klingen. Legal Department: R.K. Gordon, S. Hagan, H.N. Schiffman, R.L. Weeks. Monetary and Exchange Affairs Department: R.K. Abrams, C.A. Enoch, O.M.J. Frecaut, H. Mehran, M.M.C. Mesquita. Policy Development and Review Department: J.T. Boorman, Director; C. Daseking, J. Hicklin, G.R. Kincaid, L.J. Lipschitz, A. Masuda. Research Department: E. Detragiache. Secretary's Department: Z. Ahmed, S. Djumena, P. Gotur, B.A. Sarr. Treasurer's Department: H. Flinch. Office of the Managing Director: J.A.P. Clément, D.A. Citrin, S. Tiwari. Advisors to Executive Directors: W.F. Abdelati, S.S. Farid, C.M. Gonzalez, O.A. Hendrick, J. Jonáš, J.M. Jones, E. Jourcin, S. Le Gal, M.F. Melhem, L. Palei, J.L. Pascual. Assistants to Executive Directors: A.S. Alosaimi, T. Belay, S.A. Bakhache, K.S. Brownlee, M. Budington, M. Carlens, J. Chelsky, I.-K. Cho, J.C. Estrella, M.J. Fernández, K. Gobe, M.R. Hajian, J.K. Honeyfield, C. Josz, E. Kornitch, T.-M. Kudiwu, Lu A., W. Merz, K. Ongley, Peh K.H., M.L. Pérez, T. Presečan, D. Saha, Sugeng, U.Y. Tilyayev, G. Vigliotti, R.P. Watal, A.G. Yakub, I. Zakharchenkov.

1. REPUBLIC OF LATVIA—REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on the second review under the Stand-By Arrangement for the Republic of Latvia (EBS/98/171, 10/15/98).

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

Since the issuance of the staff report (EBS/98/171, 10/15/98), macroeconomic developments have continued broadly in line with the program and all end-September performance criteria and indicative targets were met, with one exception: the indicative limit on net domestic assets of the banking system was not met, reflecting an unexpected shift in bank portfolios away from foreign assets to domestic assets in reaction to the Russian crisis. Following the October elections, a prime minister designate was nominated in early November and negotiations for the new coalition are approaching completion. Two major parties, which are expected to participate in the new coalition government and account for nearly 40 percent of the new parliament seats, have signed letters to the Managing Director expressing their commitment to the Fund-supported economic program agreed with the outgoing government. The staff is confident that the new government will implement the policies presented in the letter of intent. The staff appraisal remains valid.

Inflation has continued to decline and reached 3.5 percent (12-month rate) at the end of September. There are indications that economic growth is starting to decelerate, in part as a result of the Russian crisis: (annualized) real GDP growth declined from 7.6 percent in the first quarter to 5.4 percent in the second quarter, and preliminary data suggest that industrial output fell sharply in September over the same month last year.

The tighter-than-programmed fiscal stance in the first half of 1998 continued through September, with a general government fiscal surplus of about LVL 6 million in the third quarter (0.7 percent of projected third quarter GDP) and a large general government fiscal surplus of about LVL 67 million for the first nine months (2.4 percent of projected GDP for the first three quarters of 1998).

On October 19, the Bank of Latvia raised its Lombard interest rates by one percentage point, reflecting developments in money market rates and the BoL's generally restrictive monetary policy; despite preliminary indications of a slowdown in economic growth, the BoL has thus far maintained a strict monetary policy as a safeguard in the current volatile external environment. Growth of credit to the nongovernment sector continues to slow, reaching 4 percent in nominal terms in September, for a 12 percent increase during the third quarter compared with 16 percent in the previous two quarters. Preliminary information indicates that commercial banks have managed to take steps to increase their risk-weighted capital adequacy ratios in September, in the wake of the Russian financial crisis; these ratios are, however, expected to decline by a few percentage points following the introduction of stricter risk-weighting of non-OECD assets effective October 1.

As agreed, at end-October, the government approved for submission to parliament a proposal to reduce the average production-weighted tariff on a set of agricultural products as defined under the program (i.e., those products with the highest tariff in each group of agricultural products) to 30 percent. Also, a proposal outlining the privatization process for the Latvian Shipping Company has been presented to the Latvia Privatization Agency. However, a decision has been postponed until the formation of a new government, raising some concerns regarding the pace of progress in large-scale privatization.

Mr. Hansen made the following statement:

Macroeconomic conditions have remained stable and economic growth, although declining in the second quarter, has remained on a favorable level during the last six months. Growth over the first half of the year is 6.5 percent on an annual basis, inflation is down to 3.5 percent (12-month rate) in September, official unemployment in the same period was 7.5 percent, and the exchange rate remains stable. Latvia's commitment to an open trade regime, earlier reflected in numerous multilateral and bilateral trade agreements, was rewarded in mid-October when the General Council of the WTO approved Latvia's accession. After the recent general elections, a new prime minister was appointed on November 3, and it is expected that a new government could be in place before the end of November. No major changes to the present economic policies are expected. Early accession to the European Union remains Latvia's overall strategic objective.

My authorities greatly value the support provided under the three consecutive precautionary Fund programs. Since the last review under the current Stand-By Arrangement, Latvia has complied with all performance criteria. There has, however, been delays in implementing two structural benchmarks relating to the privatization of large enterprises, most notably on the privatization of the state shipping company. A review of the terms and conditions for this company's privatization is still ongoing, but is expected to be concluded by end-November. My authorities realize the great importance of pressing on with the privatization process, but are careful to find the best long-term solutions as they go along.

The favorable state and outlook for the Latvian economy could have been almost entirely free from negative elements if it were not for the influence of external forces. As a small and open economy, Latvia will always be subject to external influences. Although the current account deficit will widen in the remainder of the year, there should be room for this without encountering financing constraints. For the present, the deficit is fully covered on the capital account where the lion's share is made up of foreign direct investment.

Nonetheless, staff sees the external effects stemming from the problems in Russia as the major risk to the economy. My authorities fully subscribe to this view. Let me reflect somewhat on these risks to the macroeconomic situation and outlook. As staff rightly mentions in the report, the problems in Russia will impact on the Latvian economy mainly through three channels: the banking system, external trade, and foreign direct investment.

On the first channel, the banking system, the Latvian banking sector traditionally has had a relatively high share of claims on Russian banks or government securities, which, according to the authorities' most recent data, amounts to 8 percent of the banking sector's total assets. Traditional economic ties, which remain rather strong despite the notable diversification that has taken place in recent years, is, of course, the main explanation for this concentration. Total bank sector assets are equivalent to 53 percent of GDP.

It should be noted that behind the data on banking system averages there are substantial differences among individual banks. A few banks have had exposures amounting to some 10-20 percent of their assets. At the same time, by the end of September, 13 out of 29 banks did not have any investments in Russian government papers. There are also significant differences in the quality and efficiency of banks' risk management systems.

Following an MAE mission's recommendation, the Bank of Latvia (BOL) will undertake, by mid-November, a comprehensive review of the banking system, with the view to identifying the specific vulnerabilities of each bank. However, a first assessment of the exposure of Latvian banks, both to Russia and to other CIS countries, has already been carried out. Recognizing the high risk of these exposures, and aiming at giving a clear signal to the market, stricter country exposure limits for banks were put into effect on October 1.

The BOL has also made an initial assessment of the vulnerability of each bank to indirect risks connected with borrowers who do business in Russia and other CIS countries. On average, these loans account for around 11 percent of the banking sector's loan stock, and the majority of banks have already started to make general provisions for the possible future deterioration of the quality of these loans.

As sufficient liquidity provides time needed for restructuring, liquidity has become crucial for the survival of banks exposed to Russia. For the banking sector as a whole, liquidity remains well above the required minimum (30 percent of total current liabilities), although it has declined from 70 percent in July to 52 percent in September.

Moreover, to make financial market regulation more efficient, the authorities are currently drafting a law on consolidated capital market supervision. This would put supervision over banks as well as insurance and securities companies under one independent institution.

Despite the above mentioned difficulties, the current situation could, in fact, contribute to a beneficial speeding up of negotiations on mergers of commercial banks. Further consolidation of the bank sector will allow the system to become even more stable and secure, something that was acknowledged also during our last Board discussion. The BOL will continue to work closely with banks as they seek to resolve the current situation, and the Bank remains confident that the banking sector is strong enough to withstand the challenge. Nevertheless, should the situation turn to the worse, the BOL stands ready to take the measures needed to safeguard a continued sound and stable bank system. This includes being prepared to revoke the licences of those banks that fail to restore their capital share.

The second channel is external trade. Latvian exporting enterprises have already started to report delays in payments from clients, and some have, in turn, indicated difficulties in furnishing the government with tax payments. However, trade with Russia was already declining earlier, and figures for the first eight months of the year show that Russia is no longer the largest importer of Latvian goods. Exports, which grew by 20 percent in the first half of 1998, have been redirected more towards western markets, and the European Union so far this year accounts for about 53 percent of exports. Sanctions or threats of sanctions imposed on Latvia earlier this year contributed to speeding up this reorientation. Hence, even if my authorities expect a decline in trade volumes, the impact on exports should at least be significantly smaller than it would have been some years ago because of subsequent trade diversification.

In addition, as staff notes, the transit trade with Russia accounts for a large share of Latvian service receipts. This channel will likely work in favor of the Latvian economy. As Russian exporters hope to benefit from the weaker ruble, exports of energy and metals will increase, which will boost transit trade.

In order to mitigate the loss of jobs in - and tax revenue from - exporting firms that nonetheless will occur, the government intends to stimulate exporting corporations through a two year, partly EU financed, program. The program should stimulate development of export strategies, and the exploration of new markets. My authorities have emphasized that possible short-term assistance to enterprises in difficulties will be on market based conditions, and within existing budget allocations.

As regards the third channel, foreign direct investment, it will be difficult to predict the magnitude and direction of the impact. Long-term foreign investment flows have so far been a stable source of financing for the Latvian economy. Already before the problems in Russia intensified, foreign direct investment was expected to decline somewhat during 1998. This being said, if foreign investors differentiate sufficiently among the countries in the region, Latvia should be found a relatively safe and attractive venue. Therefore, on balance, it is expected that the level of foreign direct investment should remain at a comfortable level.

Finally, I believe it is worth mentioning to the Board that on October 27 Latvia has consented to the increase under the Eleventh General Review of Quotas.

Mr. Hansen, extending his remarks, noted that the new government would most likely consist of a center-right coalition and that expectations were that they would continue the prudent financial and economic policies of the previous government.

The EU Commission had recommended that if Latvia maintained the momentum of change, it would propose opening negotiations before the end of 1999 for the incorporation of Latvia into the EU, Mr. Hansen said. The authorities were pleased with that development and considered that the timing of the negotiations was appropriate.

Mr. Esdar made the following statement:

> We concur with the analysis and recommendations of the well-focussed staff report and support the proposed decision.
>
> Indeed, the impressive achievements of Latvia during its transition process have continued. The bold reform efforts over the past years are *reflected in a strong growth performance while inflation has been declining.* The precautionary arrangement agreed last October in so far has met its full objectives. Mr. Chairman, at a time when IMF-bashing seems to have become a popular exercise, such encouraging news is certainly comforting. Also against this background our congratulations to the Latvian authorities.
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> However, also in Latvia, there are risks and challenges as rightly pointed out by staff. In this regard, in particular potential spill-over effects from the economic crisis in Russia deserve the full attention. In so far, Latvia has dealt with this challenge well. The effects on the banking system have been kept under control based on strengthened prudential regulation and banking supervision. Also, the trade exposure is quite limited. However, the situation remains fragile, and the best response in this situation would be to further improve the shock absorption capacity and to reduce possible vulnerabilities of the economy. I would like to demonstrate this in four areas.
>
> First, the financial sector has to be further strengthened and closely monitored. We therefore welcome the most recent rapid reaction of the Bank of Latvia in stepping up financial sector regulation. We are also pleased to learn from Mr. Hansen's preliminary statement that the Bank of Latvia will undertake a comprehensive review of the banking system by mid-November. We also hope that the negotiations on mergers of commercial banks will come to successful conclusions soon.
>
> Secondly, the current account deficit is still relatively high. While the medium- and long-term structure of its financing may give some comfort, experience from other countries demonstrates that a volatile environment can change financial flows and structures rather quickly. We therefore would encourage the authorities to continue and strengthen their reform efforts with the objective to increase the competitiveness of the country and to diversify the export structure. Also, an acceleration of the privatization process would improve the flexibility and effectiveness of the economy. In so far, we share the concerns expressed by staff on the pace of progress, especially with regard to large-scale privatization.

Thirdly, on the fiscal side, the most appropriate response to external shock would be to provide room for automatic stabilizers to react. Therefore, we agree with staff that a more ambitious fiscal approach at this time would improve the absorption capacity of the economy if the external environment should deteriorate. Potential areas for additional adjustment could be provided by setting upper limits for discretionary public expenditures and reductions of the tax-free zones.

Finally, on exchange rate policy, we acknowledge that the pegged exchange rate regime has served Latvia well so far. However, we would reiterate the point we made repeatedly that fixed exchange rate regimes have their limits. Potential positive effects can easily be offset if the appropriate time for the exit has been missed.

We would also be interested in having staff's view whether the SDR in the case of Latvia is the appropriate anchor given Latvia's close trade and financial links to Europe.

Mr. Chairman, we are confident that the Latvian authorities will meet the challenges ahead as also the new government obviously is committed to the reform process.

Mr. Lushin made the following statement:

Latvia is a country in an advanced stage of transition and it has continued to demonstrate a strong economic performance with substantial GDP growth and a further reduction in inflation. The program's objectives for this year have been broadly achieved and Latvia has made considerable progress toward establishing a market-based economy with an efficient public sector.

However, the Russian crisis has already started to exert a negative impact on economic indicators: thus, according to the recent data, real GDP growth declined to 5.4 percent in the second quarter and industrial output fell sharply in September. The staff has provided us with a paper that is mostly focused on an optimistic scenario. I share the view that the economic situation in Latvia remains manageable and resilient to external shocks, but I would recommend that the authorities stay alert, especially in the light of a possible lowering of investment confidence and a still somewhat unclear situation in the banking sector.

As I have no serious disagreement with the staff appraisal, I would like to limit my comments to only a few policy areas.

On the fiscal front the Latvian authorities have achieved impressive results despite the pressure of an election year. But I share the staff's view that, given the rapid private sector credit growth, the sizable current account deficit, and the volatile external environment, maintaining a cautious fiscal policy remains extremely important. In this regard, I welcome the progress in the fiscal area achieved so far this year. Given that, in the first three quarters of

1998, the fiscal surplus amounted to 2.4 percent of GDP, one can hope that a fiscal surplus for the year as a whole will be comfortably achieved.

I welcome the steps taken by the authorities to rationalize public expenditures, including elaboration of a framework for a more competitive and transparent wage structure through the civil service law that was drafted recently, as well as measures taken by individual ministries to enhance the efficiency of government spending. I also welcome the progress in furthering pension reform.

Tax administration has also improved, as reflected in revenue collection, and this is a promising sign for the overall fiscal performance. However, existing free-trade zones continue to be a worrisome issue. The proliferation of special tax regimes can seriously undermine fiscal transparency and unavoidably lead to significant revenue losses as well as tax-induced distortions in economic decision-making.

On the monetary and exchange rate policies, I share the authorities' and the staff's view that the exchange rate peg, supported by appropriate monetary and fiscal policies, has served Latvia well. There was only minor pressure on Latvia's foreign exchange market, despite the recent unfavorable developments that took place in international financial markets. I welcome the authorities' readiness to tighten fiscal and monetary policies in the event of an adverse balance of payments situation. This said, I would like to join Mr. Esdar in the assertion that in the present-day economic volatility, excessive commitment to the exchange rate peg could be dangerous at some stage. The authorities need to take note of the sad experience with pegs which has been provided by the ongoing financial crisis so far and consider possible exit strategies already now, when the economic situation is sound.

The external position of the country remains manageable, but, in my view, needs to be closely monitored. The current account deficit continues to increase, mostly due to the strong growth of imports. At this stage the deficit is sufficiently covered by foreign direct investment. However, the situation in Russia, apart from a possible unfavorable influence on Latvia's trade, may also have a negative impact on the country's ability to attract foreign investment due to the effect of contagion. In this context I agree with the staff on the importance of stimulating private savings in order to reduce reliance on foreign inflows.

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

Mr. Costa made the following statement:

The Latvian economy represents a success story which leaves little scope for critical comments. Fiscal and monetary discipline, coupled with unambiguous progress in the structural front, have laid the basis for a sustained non-inflationary growth. The strong performance of the economy and the strength of the banking sector has greatly contributed to ameliorate the seriousness of the external shock represented by the crisis in Russia. At the same time, the latter has helped to intensify the regulatory and supervisory oversight of the banking system, as well as to create the conditions for speeding up the restructuring of the banking sector as mentioned by Mr. Hansen in his comprehensive buff.

I will limit my intervention to a few short comments on the fiscal, monetary and structural policy areas. After having achieved a fiscal surplus in 1997, the economy is geared to repeat such performance during 1998 with an even higher mark. I wonder if this better than projected performance is due to the over performance of revenue, or if it is rather due to the delay in the implementation of some investment projects. The risk here is that such expenditures may come to fruition precisely when revenue performance becomes impaired due to the impact of the Russian crisis. Staff comments would be appreciated.

On the monetary area, I welcome the marked increase in the degree of monetization of the economy which at more than 20 percent of GDP is nonetheless relatively low and provides scope for further progress. This growth in the demand for domestic currency in the context of a steady process of disinflation augurs well for the expansion of domestic financial markets which will help to underpin growth. In any event, the rate of credit expansion projected at 80 percent in nominal terms during the current year, after having grown 76 percent during 1997, should raise a note of caution in particular regarding the quality of loan portfolios under stressful international conditions. It is comforting, however, that even counting for the losses on Russian sovereign debt the risk weighted capital adequacy ratio is still above Basle minimums.

More specifically on monetary policy, I would appreciate some further explanation from staff on the assertion in Paragraph 21 of the paper that in case capital flows instability threaten the macroeconomic equilibrium the authorities plan to recourse to open market operations. I understand this as saying that the authorities will attempt to counteract the impact of capital flows on the monetary supply through open market operations in the event of unstable foreign exchange market conditions. This is, to say the least, a risky strategy which, although feasible within conventional fixed exchange rate systems, may become self-defeating in terms of preserving the exchange rate stability, particularly under a scenario of capital outflows. Even under the most favorable scenario of capital inflows, sterilization can only delay the convergence of interest rates to international levels and create another type of self-defeating mechanism to the extent that it induces further inflows. It is noteworthy that real interest rates in Latvia remain at a relatively high level of 10 percent. Although the latter appears not to have induced a significant inflow of short-term capital, this situation may well revert in the future in the wake of the investment grade recently granted to Latvian exposure by credit rating agencies and also because of the stronger banking system that may result from the present crisis.

On the structural front, it is commendable that the performance criterion on land registration was fully met and that the authorities are willing to put the privatization of public enterprises back on track. Strengthening property rights and expanding the market economy is an essential element of the transformation process. This should go pari passu with a growing sense of social responsibility as is being already reflected in the exemplary compliance with tax obligations.

Finally, we support the proposed decision and feel encouraged that the new government is expected to continue the policies envisaged by the present Fund program. We wish the new authorities success in facing the remaining challenges in the transformation process, particularly now under difficult external circumstances.

Mr. Nelmes made the following statement:

As outlined in the staff report and by many Directors here today, the economy has performed extremely well under the stand-by arrangement. I have no difficulty in supporting the proposed decision. I have only one concern that I would like to raise, where my view differs from that of the staff, and this concern is very much the same as that expressed by Mr. Esdar earlier, and echoed by Mr. Lushin.

The staff notes that the exchange-rate peg has served the economy well and will remain a key feature of economic policy. Indeed, the peg has clearly provided a broad degree of stability to the domestic economy in the recent past. However, this favorable outcome occurred in an environment largely absent of external shocks of direct importance to the Latvian economy prior to the Russian crisis. With the array of adverse external shocks presently impinging on the Latvian economy now, though, it is not clear to me that the pegging to the SDR will continue to serve its purpose as well in the future as it has in the recent past.

First, the currency weights in the SDR do not reflect accurately the composition of Latvian trade. For example, Russia accounts for about 16 percent of total exports, but its SDR weight is zero. By pegging the lats to the SDR, therefore, this mismatch implies that the sharp depreciation of the ruble since August will result in an appreciation of Latvia's trade-weighted effective exchange rate and a tightening of monetary conditions.

Moreover, the negative demand shock emanating from Russia will have a significant direct adverse impact on Latvia's current account deficit. In the absence of allowing the exchange rate to adjust to the external shock, either the current account will deteriorate to a greater extent than otherwise, or the domestic economy will have to go through a bout of relative wage and price deflation in order to restore competitiveness.

Neither option, in my view, is necessarily preferable to a degree of orderly exchange-rate adjustment. Running current account deficits on the order of 7 to 8 percent of GDP in today's environment of finicky international investors is, to my mind, risky. And while strong inflows of foreign direct investment have covered current account deficits in the past, such inflows may deteriorate in light of the current state of investor uncertainty with respect to emerging economies. In any event, a prolonged or a significantly worse-than-expected deterioration in Latvia's current account runs the risk of creating concerns over the possibility of a more abrupt and disruptive change in the exchange-rate regime at some point in the future.

With respect to the need to restore competitiveness through relative wage and price deflation, given the tightening of monetary conditions represented by the effective appreciation of the lats, it is not surprising to read in the staff statement that inflation continues to decline while underlying inflation is close to one percent, and presumably also declining. In addition, the balance of risks points to a slowing of domestic demand (where industrial production has turned negative) and a slowing of global economic growth next year. Against this backdrop, maintaining a low, steady, but positive rate of inflation in Latvia may require some degree of stimulative policies be put in place. With monetary policy geared to maintaining the exchange-rate peg, the burden of action will necessarily fall on fiscal policy. However, moving toward fiscal dissavings will only work to exacerbate the external imbalance, not improve it.

In light of these considerations, I would welcome staff's comments on the best policy response in the event that inflation turns out to be weaker than anticipated, and the current account deficit larger than expected in 1999, and under what circumstances would the staff would consider proposing an exit strategy from the peg?

Mr. Spraos made the following statement:

Latvia's is one of the better performing economies among the countries of the former Soviet Union. Latvia's aspiration to join the European Union as soon as possible received a big boost when a couple of days ago the European Commission declared, as Mr. Hansen has already told us, that, if progress continues, Latvia's accession could be accelerated before the end of 1999. I welcome that.

At the same time, the hunger for success stories from the countries of the former Soviet Union should not blind us to the unpalatable sides of the Latvian economy. Real GDP is less than 60 percent of GDP in 1990. We are not comparing exactly like with like but the gap is huge by any standards and at the projected rate of growth of 6 percent per year—and that is the optimistic scenario—it will take 9 years to reach the former level. Job seekers, not just registered unemployed, have been estimated by official agencies at 16-19 percent of the labor force and there are also half as many involuntary part-timers and a significant number of "discouraged" persons (Selected Issues, SM/98/70). No matter how well intermediate targets are achieved, the ultimate targets of income and employment are the ones that matter most.

In terms of macroeconomic balances, Latvia is doing quite well. Were it not for the fallout from the Russian crisis, I would have said very well. But the Russian crisis has weakened the banking system and the news on this front in the last few days suggests that it may have weakened it more than was thought. Confidence in the currency has been growing, but the fact that 50 percent of bank deposits is in foreign currency suggests that it has some way to go. And, from the standpoint of the banking sector's health, large foreign currency deposits can be malign unless properly hedged. Russian bonds, for example, are not a good hedge for dollar liabilities. It is to be hoped that the supervisory authority watches out for mismatches of currencies, maturities, etc.

The large expansion of the monetary aggregates, which is rightly viewed by the staff and the authorities as benign—the manifestation of monetary deepening—implies big seignorage gains which must be reflected in large central bank profits. Apparently the Bank of Latvia does not transfer all its profits automatically to the government budget. So it needs to be publicly accountable for the use of its profits in some other way. If recapitalizing of banks becomes needed in the wake of the Russian crisis, this would be a useful nest egg to call upon.

The budget is strong even if we transfer privatization proceeds below the line, where they belong.

The current account shows a deficit. The estimate for 1998 is 5.5 percent of GDP. In the phase of economic development that Latvia is in, this is not inappropriate if FDI inflows can cover a major part of it. In fact they have been more than covering it in the last few years. In 1999 they may fall short, but that will be due to a (hopefully transitory) deterioration of the current account due to the Russian crisis. I recall that FDI flows have been resistant to the volatility displayed by other capital account items in the last 18 months. But the rising trend of the current account deficit in the last five years does need watching. Maybe it would be worth identifying a little more closely how much is due to the growth of capital goods imports.

Clearly there are fragilities in the current situation but in the last part of my remarks I would like to focus on a medium-to-long-term worry. As I said at the beginning, at the projected 6 percent growth rate, it will take nine years to regain the GDP level of 1990. Less on a per head basis, but still a long time. And 6 percent growth is the optimistic scenario. Urgent attention needs to be paid, I think, to policies that can push the growth rate higher. Right now, the fragilities which hang in the air probably preclude a more energetic pursuit of growth enhancement. But Latvia has, in my judgment, fewer macroeconomic vulnerabilities than a neighboring country that is also performing well. So there is, I believe, scope for aspiring higher. I hope, therefore, that when the climate becomes more settled, we can begin to think about how to achieve a faster pace. The high level of unemployment will not be diminished fast enough without an acceleration in the pace of growth. The routine attribution of unemployment to labor market rigidities would find few pillars on which to rest in the Latvian context. (The minimum wage might be one, but it is less than a third of the average wage. And is it enforced?) So this is another reason for less conservativism in seeking higher growth. The timing must be right. But I hope it need not be delayed too long.

I support the proposed decision.

The staff representative from the European II Department noted that the Latvian authorities' policy concerning the exchange rate was to wait until an association with the euro was formed. While Latvia would not be moving towards an exchange rate peg with the euro, exchange rate policies would be geared at minimizing deviations from the euro. While there was a risk that that could lead to a short term deterioration of competitiveness, indications of competitiveness were strong, despite the developments in Russia, due to the substantial increases in productivity in Latvia.

Open market operations of the Bank of Latvia were relatively minor since there was not a very developed treasury bill market, the staff representative remarked. Monetary policy measures had principally involved raising repo rates and restricted refinance credit.

The Latvian authorities were taking steps to resolve the banking problems, including a possible closure of more small banks, the staff representative said. The staff were optimistic that the banking sector problems could be resolved, and had urged the authorities to continue its vigilance in that regard.

The staff were hesitant about the need for fiscal stimulative action, as the magnitude of the impact from Russia, or of a global economic slowdown, on the Latvian economy was not yet ascertained, the staff representative stated. In the medium term, there should be a set of policies to stimulate economic growth, but that would not necessarily be best achieved by fiscal easing. The staff considered that growth should primarily be stimulated in the medium term through continued structural reforms and privatization.

The better than expected public investment performance was almost entirely due to much higher than anticipated revenues, the staff representative from the European II Department.

Mr. Esdar noted that while the exchange rate was relatively stable compared with the other east European countries, there had been a major real appreciation vis-a-vis Latvia's main market partners. Did the staff consider that the real exchange rate would stabilize, or would it appreciate further?

The staff representative from the European II Department replied that the exchange rate needed to be monitored carefully. While the authorities recognized that the peg to the SDR was not quite right given the trade patterns, they intended to move away from the SDR peg to an exchange rate that was connected with the euro. That would eliminate a lot of the problem of the exchange rate moving because of movements between SDR and European currencies. Other indicators of competitiveness in Latvia had been strong, including export performance.

It had not been possible to do more sophisticated calculations of competitiveness in Latvia, such as unit labor cost comparisons, because the data was not thorough enough yet, the staff representative continued.

Mr. Spraos pointed out that the *Financial Times* report on Latvia indicated that the banks ranked from 2 to 5 in size were being seriously affected by events in Russia. The banking sector problem had not been perceived to be as large of a problem as it turned out to be.

While current GDP and GDP in 1990 were not directly comparable, were there any estimates of the consumer's basket comparing what could be bought in 1990 versus what could be purchased today, Mr. Spraos asked.

The staff representative from the European II Department replied that the *Financial Times* article was right in pointing out the problems in the large banks, although the Bank of Latvia was aware of those problems for quite some time. The Bank of Latvia recognized that those major banks had undertaken provisioning measures and reduced their exposures, but the Bank of Latvia considered that more needed to be done. Clearly, the banks in Latvia were in a fragile situation, and close monitoring of progress would be needed.

While there were sporadic estimates in individual studies that compared purchasing power for consumer goods in Latvia, the data was very limited, the staff representative said.

The staff representative from the Policy Development and Review Department remarked that the staff had looked carefully into the situation of the Latvian banking system. While the recent press releases were not news to the staff or to the Latvian authorities, they could change the perceptions of the market about the strength of the banking system in Latvia. Nevertheless, the magnitude of the shock that was affecting the Latvia banking system was smaller than the shock that hit the Nordic banking system in the early 1990s. In addition, the Latvia banking system had an extremely high level of capital relative to its risk-weighted assets, on the order of 20 percent. That ratio would undoubtedly fall following the losses in the banking sector, but the banking system still appeared to be solvent. Public sector action, at the current stage, did not appear to be warranted.

Mr. Goffinet made the following statement:

> At the outset let me congratulate the Latvian authorities on the impressive results achieved under the Stand-By Arrangement. They can be proud of having placed their economy on a path of durable stability and growth. Prudent fiscal and monetary policies, and major structural reforms, have led to a favorable macroeconomic situation. GDP growth is impressive, inflation has declined, and the fiscal outcome has been good. Confidence in Latvia's economic policy and banking system has grown, and though the unemployment rate is still too high, it has declined slightly. All these positive developments are to be seen as a reward for the political will and determination of the authorities to get on with the macroeconomic reform process.
>
> I heartily agree with the staff that Latvia merits our full support.
>
> It is, as always, important not to let these positive developments lead to complacency, and the authorities must guard against any relaxation of their efforts to strengthen their economy further and make it resistant to the growing risks coming from the external environment.

Despite a major strengthening of the financial sector since the last banking crises, today's unfavorable external environment has already impaired the soundness of Latvia's financial institutions. I urge the authorities to redouble their efforts to reinforce their banking regulations, especially in the areas of rules for large credit exposures and regulations for dealing with country risk.

Latvia has made an energetic effort to diversify its export base, but the possibility that the current account might deteriorate is not completely eliminated. Already it is expected that reduced exports and a loss of investor confidence in the region as a whole could further damage Latvia's balance of payments and hence the economic development. It is therefore urgent to strengthen investor confidence and improve Latvia's competitiveness further.

Rationalizing the structure of public spending, downsizing the public sector and improving its transparency, giving the private sector a larger role, and improving the legal and judicial systems will be important steps in that direction. Keeping the budget balanced will greatly enhance the strength of the economy. It would also be wise to phase out tax free zones.

I welcome the progress made with pension reform, and urge the authorities to continue their efforts to arrive at a cost efficient, socially just, financially sound pension scheme. Why should Latvia not set a good example for other countries in the process of reforming their social security systems?

Let me end by finally stress my conviction that Latvia will meet all the challenges to become a welcome member of the European Union.

Mr. Djaafara made the following statement:

We welcome the continuing favorable development of Latvian economy. The economic growth remains high; the inflation rates declines; and the current account deficit turns out to be lower than expected. This favorable economic condition is the pay off of strong commitment of the authorities to pursue sound macroeconomic policies. The favorable economic development and sound macroeconomic policy have also attracted foreign direct investments, which in turn, push further development of Latvian economy.

Nevertheless, Latvia still needs to remain vigilant to any sign of misalignment in its economy in order to maintain the momentum of encouraging economic development. This alertness become more important in the current situation in the international financial market which has already brought severe adverse effect to the Russian economy, one of the major trading partner of Latvia. In this light, we join the staff in encouraging the authorities to be cautious on development in the current account deficit. Even though current account deficit has been managed to be lower than expected, it is still relatively big. Moreover, the staff has projected that current account deficit to reach seven percent of GDP in 1999 as the result of unfavorable development of external sector. Under the normal condition, we might propose a more flexible exchange rate to push more exports in order to improve the external balance. In this international financial turbulence, we share the staff's assessment to maintain the current exchange rate. However, Latvia still need to pursue economic policy that can improve its external balance, as substitute of exchange rates adjustment.

In this light, we sense the urgency of privatization and cautious fiscal policies . On privatization front, we join the staff in encouraging the authorities to set a realistic time table on privatization. Privatization will increase the efficiency in Latvian economy which is needed to enhance Latvian competitiveness. On the fiscal front, we welcome the readiness of the authorities to pursue tighter fiscal policy if the external situation is deteriorated sharply. Given the magnitude of government sector in the economy which is around 40 percent of GDP, the reduction in government spending will be able to control aggregate demand significantly. However, we do believe that the authorities and the staff realize the difficulties in pursuing the tighter fiscal policy when the time comes. Therefore, in this respect, we would like to *suggest to the authorities to prepare a priority list of budget items that are* eligible to cut.

With these remarks, we support the proposed decisions and wish the authorities continued success in meeting the challenges ahead.

Mrs. Fernández made the following statement:

Since the first review under the Stand-By Arrangement, Latvia has continue its important efforts to be at an advanced stage of transition with the realization of more than favorable economic developments. In fact, an economic performance characterized by the implementation of cautious financial policies, an exchange rate pegged to the SDR and structural reforms in several areas have made it possible to achieve a solid GDP growth, a fiscal surplus, a declining inflation rate and an overall balance of payments relatively strong. I congratulate the Latvian authorities for their determination and wish the new government all the luck to attend, at least, the success of its predecessors. In addition I want to thank the staff for its good work.

I agree with the staff's appraisal, that's why I will be very brief. Latvia's policies merit the support of the Fund and therefore the second review of the Stand-By Arrangement should be completed.

Nevertheless, it has to be taken very seriously that the unsettled international environment, notably the Russian crisis, threatens the continuation of such a good performance. As it is described in the staff report, recent developments in Russia have already had an important impact on Latvia's financial and external sector.

In relation with the financial sector, the determination of the Bank of Latvia, first, to take all the necessary actions if the banking system enters in another difficult financial situation; and, second, to implement high supervision standards are most welcome.

As far as the external sector is concerned, the Russian crisis will indubitable widen a current account deficit that already represents a high 5.2 percent of GDP. This particular point merits a special attention. Taking into consideration the important roll played by foreign investment in financing this current account deficit, and the context of international uncertainty, the Latvian authorities should consider that their capacity to attract foreign investment can change dramatically. Therefore measures should be taken to find other sources of financing and like the staff proposes, private savings can be one. Obviously, the determination of Latvia's authorities to tighten fiscal and monetary policies if the balance of payments shows difficulties are most welcome.

To sum up, in my opinion it is so important for Latvia not to abandon the prudent macroeconomic policies that are been implemented; and to keep on moving forward the completion of the program of structural reforms, above all in enterprise privatization, where measures are being unfortunately taken with some delays.

I wish the authorities all the best in these endeavors.

Mr. Hagan made the following statement:

I would like to begin by congratulating the Latvian authorities on the continued strong performance of the economy in 1998. Latvia's policies have moved the economy further along the path of sustainable high-quality growth and merit the support of the Fund, and the international community more generally. Therefore, I am happy to support the recommendation to complete the second review.

The main risks to the economy come from the external situation, and particularly the effects of the events in Russia. Of greatest concern are the effects on the banking system. I commend the measures which the Bank of Latvia is taking, particularly an early comprehensive review of the exposure of the banking system and the enforcement of the stricter country exposure limits. It may be too much to hope that current events will in the long run be beneficial by helping to rationalize the banking system further, and I endorse the staff's comments about always ending on a note of caution when talking about the Latvian banking sector.

I note the dangers of the Russian situation to exporting enterprises, but it is encouraging that the effects are relatively small, and that the economy should be able to withstand them relatively easily, albeit with an accompanying reduction in overall growth.

I note the delays in privatization process that has led to the nonobservance of two important structural benchmarks. The Latvian authorities have shown their ability to press ahead on many other fronts and I hope that at the next discussion we will be told of significant progress on privatization.

I welcome Latvia's new status as a member of WTO. For a small economy like Latvia, free access to markets, particularly western markets, is of great importance. While most developments have been encouraging, my authorities have heard that tariffs on certain agricultural owned imports from other Baltic countries have recently been raised, despite the free trade agreement. Could the staff comment on the authorities' general approach to the trade regime and, in particular, the Baltic free trade area.

Mr. Melese d'Hospital made the following statement:

I would like to thank staff for their hard work and for an appropriately nuanced paper.

Briefly, the authorities are to be congratulated for doing most everything right and making respectable efforts in the relatively few problem areas. In particular, on privatization, which Mr. Havrylyshyn rightly highlighted as a source of future growth, enterprise privatization is coming to a close, although it is not over until it is over and key large infra structural entities (Latvenergo, *Shipping Co.) are pushed out the door. Apartment privatization,* the importance of which we have underlined in the past as much for psychological as for practical economic reasons, has now reached 32 percent with a target of 40 percent at year's end; this is not as much progress as we would have hoped for, but nonetheless represents material movement in the right direction. Land privatization is also moving, with 160,000 properties registered in the Land Book (cadastre) at end-June with a target of 190,000 at year's end. Bottom line: Latvia is well advanced on the road to becoming a normal, Western market economy, one where economic actors can go about the vital if mundane business of allocating their labor, land and capital for maximum profit.

Regarding the risks and challenges faced by the authorities, I would align myself with the comments of Mr. Esdar and others regarding the importance of strengthening financial sector regulation and of policies to address the current account imbalance, including export diversification and continued prudent macroeconomic policies, as well as of further measures to improve the investment climate, with a view to attracting increased stable, long-term flows of investment. I would also like to align myself with the comments of Mr. Lushin on the desirability of reducing reliance on free trade zones (FTZs).

Finally, I would like to applaud the authorities for their efforts in the area of good governance, the importance of which cannot be underestimated for the medium-term growth prospects of economies in transition. I strongly urge them to follow through on initiatives in this area, with a view to creating the kind of business environment which will serve as a magnet for international trade and investment far into the future.

The staff representative from the European II Department said noted that the Latvian economy was already extremely open with the exception of a few goods in the agricultural sector. Even on those sets of goods, however, the direction of the debate was to have more trade openess.

Mr. Hansen expressed concern about the size of the balance of payments deficit, but noted that the major part of that was capital equipment. Norway had a similar situation in the late 1970s, but capacity had since been built up, and Norway was currently doing pretty well on that front.

While the banking system problems needed to be followed closely, the authorities were acting with a high level of determination and efficiency in addressing banking sector issues, Mr. Hansen concluded. The central bank would likely support the banking system in case of liquidity problems, but in the event of insolvency problems, the authorities would have a very critical view.

The Executive Board took the following decision:

1. The Republic of Latvia has consulted with the Fund in accordance with paragraph 3(e) of the Stand-By Arrangement (EBS/97/174, Sup. 1, 10/14/97) and the second paragraph of the letter from the Minister of Finance and the Governor of the Bank of Latvia dated September 8, 1997.

2. The letter from the Minister of Finance and the Governor of the Bank of Latvia dated September 29, 1998 shall be attached to the Stand-By Arrangement for the Republic of Latvia, and the letter dated September 8, 1997 with attached memorandum, as amended by the letter dated March 9, 1998, shall be read as supplemented and modified by the letter dated September 29, 1998.

3. The Fund decides that the second review contemplated in paragraph 3(e) of the Stand-By Arrangement is completed, and the Republic of Latvia may proceed to make purchases in accordance with the provisions of the arrangement. (EBS/98/171, 10/15/98)

Decision No. 11823-(98/114), adopted
November 6, 1998

2. ETHIOPIA—INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—PRELIMINARY ASSESSMENT OF ELIGIBILITY

The Executive Directors considered a paper, prepared jointly by the staffs of the Fund and the International Development Association, presenting a preliminary assessment of Ethiopia's eligibility for assistance under the Initiative for Heavily Indebted Poor Countries (EBS/98/173, 10/16/98; and Rev. 1, 10/29/98).

The staff representative from the Policy Development and Review Department made the following statement:

A number of Directors have raised questions about the degree to which there is a precedent for a country being considered for a decision point after only six months or one year of track record. This is the first clear case of a country coming to this point following a break in the track record, in this case in the first annual arrangement under the ESAF-supported program. The staff has been guided by a couple of papers that went to the Board in 1996. In one, the staff had decided that credit could be conditional on the country successfully implementing at least one further annual ESAF arrangement immediately prior to the decision point, as part of a three-year track record, once there had been an interruption. The Board's views, which were more clearly encapsulated in the program of action later that year, were not as specific on the amount of time required before the track record was established. It was clearly stated that this would have to be decided by the Board on a case-by-case basis. In the case of Ethiopia, the staff of both the Fund and the Bank agreed that a generous interpretation of the earlier guidelines would argue for a decision point in spring 1999. Although the ESAF arrangement would not have been tested for a full year at that time, it would be past the midway point. Meanwhile, there was much less evidence of a break in track record, particularly on the structural side, from the Bank's perspective. Those were among the considerations included in the staff's proposed decision, but we look forward to hearing the Directors' views on the matter.

Mr. Morais made the following statement:

My Ethiopian authorities welcome today's discussion, which should start the process for their country to benefit from debt reduction under the HIPC Initiative. Indeed, much has already been accomplished in laying the foundation for moving this process forward. This can be seen in Ethiopia's track record of economic reform, which began in 1992 with a successful program supported under the Structural Adjustment Facility (SAF). Recently, on October 23, 1998, the Board considered and approved Ethiopia's request for a second annual arrangement under the Enhanced Structural Adjustment Facility (ESAF). There was broad agreement that the authorities had taken significant strides in deepening economic reforms, and particular note was taken of the fact that the lapsing of the first annual arrangement did not derail the reform agenda. This is evidence that the authorities are staying the course because they believe that the transformation of their economy is the right process to attain rapid growth and poverty reduction. Indeed, there is a strong commitment to put the country irreversibly on the road to a market-oriented economy. This is important for gauging the future direction of the reform process in the context of making a determination regarding the decision and completion points under the HIPC Initiative.

The staff paper on the Initiative for Heavily Indebted Poor Countries for Ethiopia (EBS/98/173, Revision 1) highlights the track record of the authorities, which has been built on several important themes: deregulation and liberalization; private sector development, including increased participation of foreign investors; lessening Ethiopia's vulnerability to supply shocks; stabilization, based on sound fiscal and monetary management; improved social services; and infrastructural development. Together, they represent a road map for high growth and the reduction of poverty in Ethiopia.

Despite the progress made thus far, the task ahead remains quite challenging. Ethiopia is one of the poorest countries in the world. The need for strong support from the international community, therefore, cannot be overemphasized. In this connection, significant and timely debt relief is very important. The debt sustainability analysis for Ethiopia done by the staffs of the International Development Association (IDA) and the Fund shows that the debt overhang is one of the highest of all the HIPC Initiative cases, and that it could put at risk the country's adjustment and reform efforts if it is not addressed in a timely manner.

This leads to the modalities for the HIPC Initiative. On the question of the decision point, Ethiopia's track record of adjustment and the accomplishments under difficult circumstances make a strong case for agreeing on a time that coincides with the mid-term review of the recently agreed ESAF program in April 1999. That would be at least an additional six-month track record, which should be enough to demonstrate the authorities continued commitment.

Regarding the completion point, we have always emphasized the need for a shorter track record. An important advantage is that it allows countries like Ethiopia, that are committed to economic reform to get the benefit of debt relief sooner rather than later. Such timely action would also help a government to build domestic support for deeper reform.

In the particular case, the authorities are requesting that the completion point should be within the period of the current medium-term program, which runs to June 2001. The implementation of the program, which has already prompted a number of major policy measures, should be an indisputable indication of the government's commitment to consolidate the process of reform. As has been suggested, the program is not a new endeavor; it is the strengthening of the on-going process of reform. All of the core measures would have been put in place. Accordingly, we believe that Ethiopia deserves the granting of earlier debt relief. We should also take cognizance of the increased leeway that earlier debt relief would create for the authorities to direct more resources to improving social indicators, which are significantly weaker than in almost any other country in the world. Timely relief of Ethiopia's debt burden would also contribute positively to the strengthening of private sector confidence in the economy.

Finally, the debt sustainability target. Several factors justify having a target of 200 percent or lower. Directors should consider the country's low level of development, its narrow export base, which leaves it highly vulnerable to terms of trade shocks, its vulnerability to bad weather conditions, and that the country's debt burden is the worst of all the HIPC Initiative countries. There is also uncertainty regarding official transfers. Moreover, the debt analysis is based on long-term projections, which add to the uncertainty of the sustainability target.

Mr. Pickford made the following statement:

I would like to thank both staffs for their comprehensive report, which sets out the background to this case. I also thank the staff for the statement he has just made.

The Ethiopian government has made significant progress in stabilizing macroeconomic conditions and liberalizing the economy in the past few years. GDP growth has been consistently strong, at about 6 percent. Inflation has basically been eliminated from the high of 21 percent in 1991-92. The fiscal deficit, excluding grants, declined from 9 percent in 1991-92 to 6.6 percent in 1997-98. Significant progress has been made on the structural side, with tariff reduction, the liberalization of the current account, and the opening up of opportunities to foreign investors. The resumption of the ESAF-supported program two weeks ago was a welcome step, which moves Ethiopia more firmly toward the path of sustainable development and poverty reduction.

We strongly support the staff conclusion that Ethiopia is eligible for debt relief under the HIPC Initiative, given the country's efforts in recent years. The government has maintained its long-term commitment to economic stability and exhibited firm control over the macroeconomic aggregates, despite the recent interruption, with the obvious and important exception of defense expenditure. It is regrettable that defense spending, which had been reduced significantly in the first three quarters of the decade to about 2.2 percent of GDP, rose again to 4.7 percent in 1997-1998. I am glad that the government has indicated that military spending will return to the 2 to 3 percent range. It is important that the government stick to that objective. We can thus support the staff proposal that the HIPC Initiative decision point follow the midterm review of the recently agreed ESAF-supported program.

On the question of the completion point, the United Kingdom has consistently argued that the required track record is too long and does not allow countries' exceptional reform efforts to be recognized by earlier debt relief. The timing of the completion point does not need to be decided now, but, in recognition of Ethiopia's long track record, we would suggest that it be linked to the completion of the first year of the successor ESAF-supported program, in autumn 2001.

We accept the authorities' desire to weigh the policy options and sequencing of reforms, although a faster pace of reform in key areas is more appropriate to meet the objectives. The main priorities include speeding up economic and social development through growth and liberalization of the private sector, encouraging foreign investors' participation in reconstruction, and raising domestic private capital. We urge the authorities to build rapidly on the progress made so far on tariff reform, revising the Investment Code and exchange control reform, and perhaps setting firmer action dates for progress.

Trade reform and export promotion are central to the success of Ethiopia's economic policies, which rely heavily on agricultural export-led growth and are ultimately central to debt sustainability. The previous reduction in tariffs is welcome, as is the liberalization of payment and exchange regulations for foreign trade in goods and services. However, we urge a faster pace on further tariff reductions. We also look for a quicker pace of progress on privatization, which could be part of the upcoming privatization action plan. Banking sector liberalization must be accelerated, particularly in the areas of supervision, resolving the issues related to the central bank of Ethiopia, and opening up the sector to foreign banks. An efficient banking sector is essential to private sector investment, both foreign and domestic. We expect priority sector expenditure to be protected and further progress to be made in developing pro-poor policies. We look forward to Ethiopia making strong progress in that regard by the time of the midterm review.

Regarding the debt sustainability target, the vulnerability analysis notes Ethiopia's reliance on agricultural products for exports, especially the dominance of coffee. Ethiopia is also vulnerable to weather and terms of trade shocks. We therefore support the staff proposal for the target for debt sustainability to be set in the lower part of the suggested range of 200 to 220 percent. We would prefer a target of 200 percent, in order to ensure as robust an exit as possible from debt rescheduling.

Debt reduction will allow Ethiopia to move firmly on a path of sustainable development. We are confident that the government will meet the challenges needed to achieve that, and wish them well.

Ms. Turner-Huggins made the following statement:

We welcome today's discussion of the preliminary HIPC Initiative document for Ethiopia, and commend the staff for bringing this paper to the Board. We particularly appreciate the clear and thorough application of the HIPC Initiative framework to Ethiopia, and underline our support of the staff's inclusion of Tables 11 and 12, comparing debt service before and after debt relief. For the sake of transparency, this practice should be continued.

We appreciate the explicit discussion of the risks associated with the lingering border dispute, highlighting the possible impact on social spending. We are pleased that the Ethiopian government has repeatedly reiterated its commitment not to allow the dispute to detract from the reform program. As noted in the ESAF-supported program discussion two weeks ago, we welcome the transparent approach to any unforeseen military spending being covered out of extraordinary resources or expenditure cuts in nonpriority areas. We hope for a positive outcome of the discussions this weekend.

Like Mr. Pickford, we consider Ethiopia to be eligible for the HIPC Initiative, and view this Initiative as an important catalyst to achieving sustainable economic development and alleviating poverty. This chair two weeks ago considered the reform process to be well under way and commended the Ethiopians for the reforms attained so far.

We do not have any difficulty with the staff's suggestion of a spring 1999 decision point. This is especially appropriate in light of the midterm review process. Our chair also favors a three-year second stage, as proposed by the staff. However, if in the period between now and the decision point, performance under the ESAF-supported program and IDA program significantly exceeds expectations, we would be prepared to consider the more generous completion date of autumn 2001, as suggested by Mr. Pickford. I also agree with the points in Mr. Morais's statement about the impact of timely relief on strengthening private sector confidence, as well as on the government's ability to build domestic support for deeper reforms.

To ensure a durable exit from the rescheduling process, we favor a debt sustainability target of 200 percent, as opposed to the lower end of a 200 to 220 percent range. We prefer a specific target, as in other cases. I agree with the factors highlighted by Mr. Morais, including Ethiopia's vulnerability to trade shocks and natural disasters.

Regarding military versus social sector spending, we have deep concerns about what the authorities may do when faced with an actual conflict. Proposed cuts in nonpriority areas can carry risks to the overall effectiveness of health and education budgets. Renewed conflict could affect the delivery of social service, and we worry that these impacts have not been fully assessed. We, along with other members of the international community, urge the government to make substantial efforts toward a durable resolution of the conflict with Eritrea. We wish the Ethiopians well in all of their difficult tasks ahead.

Mr. Elhage made the following statement:

Given that the discussion of the medium term program took place two weeks ago and resulted in the approval of the second annual ESAF arrangement we will limit our remarks today to the issues for discussion in the HIPC Initiative document.

Like Mr. Pickford, we believe that Ethiopia has established a strong track record. The Ethiopian authorities have been committed and in fact have been implementing structural reforms and macroeconomic adjustments since the establishment of the Transitional Government in 1991. The paper in front of us makes a clear case that despite the progress made under several programs as well as the debt rescheduling operations with the Paris Club, the debt burden remains unsustainable. Therefore, we believe that Ethiopia is eligible for assistance under the HIPC Initiative. Regarding the decision point, the spring of 1999 following the conclusion of the mid term review of the second year ESAF-supported program seems appropriate. However, we have a clear preference for an earlier completion point that coincides with the end of the current medium term program (June 2001). Mr. Morais in his preliminary statement underscored the benefits of an earlier debt relief. Finally, on the NPV debt-to-export ratio, we would prefer a target of around 200 percent.

Mr. Fernandez made the following statement:

Given the Board's discussions during the previous meeting, I will not come back to the content of the ESAF-supported program and to the conflict between Ethiopia and Eritrea, except to recall that this conflict remains a matter of concern and that my authorities hope for a peaceful resolution as soon as possible.

As regards today's discussion, I would like to briefly express my views on eligibility, decision point, completion point and target.

First of all, like Mr. Pickford, we endorse eligibility under the HIPC Initiative being granted to Ethiopia, one of the poorest countries in the world. This eligibility implies further macroeconomic adjustment and structural reforms, and should allow the authorities to strengthen their efforts in the social sectors, and to improve the country's infrastructure, in collaboration with international financial institutions and donors.

Second, I agree with a decision point following the satisfactory conclusion of the midterm review of the second annual ESAF arrangement. Currently, this review is expected to take place in the spring of 1999. Naturally, any delay in such a satisfactory conclusion should lead to a delay of the decision point.

Third, concerning the completion point, I share the staff's recommendation, as Ethiopia's track record does not allow to envisage a shortening of the interim period. Of course, this three-year period implies three years of a good track record under the current annual ESAF arrangement and its successors. In this regard, it may be recalled that, in case of delays in program implementation, the fiscal year of reference would have to be accordingly adjusted. Such a change would have an impact on the calculation of the debt-to-export ratio, as well as on the amount of assistance needed to reach the target.

Finally, assessing a precise debt sustainability target is challenging today. First, while I agree that Ethiopia's economy is vulnerable to exogenous shock, this vulnerability is not as great as for other HIPC Initiative countries. On the exports side, the share of the three main products and the variability are well below the average. On the fiscal side, Ethiopian ratios are moderate relative to other HIPC Initiative countries. Second, in the baseline scenario, international coffee prices are forecast to decline by 25 percent over the next three years. This assumption seems quite pessimistic, and I would be interested to test the incidence on the debt to export ratio of a smaller fall or even a stabilization of coffee prices. To conclude, I am ready today to support a target in the middle of the 200-220 percent range.

Mr. Faini made the following statement:

In the recent discussion of the Board, this chair expressed the view that strong conditionality is an essential feature of the HIPC Initiative. We fully agree that Ethiopia fits the requirements for the Initiative. It is one of the poorest countries of the world, and suffers from a large debt burden that traditional debt relief mechanisms are unlikely to reduce in an adequate way. Moreover, it is undergoing a major adjustment effort, with the support of the Fund.

According to the staff, Ethiopia could reach the decision point in the spring of 1999, six months after the start of the ESAF-supported program. The staff recommends that the completion point then be reached three years later, in 2002, thus shortening the first stage drastically, but not the second. We are somewhat puzzled by this recommendation. We would have expected just the opposite—a somewhat longer first stage, conditional upon a sustained record of strong performance, and a considerably shorter second stage. This would conform to standard practice under the Initiative. While the second stage has typically been made shorter in five out of six cases, there are no precedents, as the staff points out, for such a drastic shortening of the first stage. Moreover, Ethiopia's track record of adjustment has been strong, but not impeccable. In October 1996, the program went off track six months after it was approved. As the staff said, we are in somewhat uncharted territory. The paper on procedures for the HIPC Initiative argues that credit can be given for previous implementation, provided that the country implements at least one further annual ESAF arrangement prior to the decision point. This chair argued in September 1998 that the HIPC Initiative's principles and procedures must be followed if it is to be successful. We are deeply committed to preserving the basic motivation of this Initiative. The decision point should thus be in October 1999, giving one additional year of adjustment record, which would be consistent with the letter and spirit of the Initiative. At that time we should consider whether the second stage should be shortened, perhaps drastically, in light of Ethiopia's track record. I see no need to commit ourselves to a three-year second stage.

Mr. Barro Chambrier made the following statement:

Let me commend the staff for the clarity and the presentation of this report. I can easily associate myself with the statement made by the previous speakers. Since the end of the civil war in Ethiopia in 1991, the authorities have made considerable efforts to rebuild their country and implement policies aimed at promoting economic growth and alleviating poverty. At the same time, they have had to use a sizeable share of their scarce resources to meet their external debt service requirements. In the assessment of the staff of the Fund and the World Bank, Ethiopia's external debt remains heavy. Given the burden shown in the various debt indicators, the weak social indicators, and the lack of critical infrastructure, therefore, we support the view that Ethiopia should be eligible for assistance under the HIPC Initiative.

Regarding the decision point, the authorities have been able to establish a strong record under difficult circumstances since the country embarked on an economic reform process in 1992. Despite the fact that the midterm review under the first-year arrangement could not be completed, further progress was made under the ESAF arrangement. We thus support the proposal to fix the decision point at the time of the conclusion of the midterm review of the second-year ESAF-supported program.

We share the concerns expressed by other Directors that the timing for the proposed completion point might be too long, given the effort already undertaken and the country's needs. We support the view that the completion point could be brought forward to 2001, at the end of the three-year program.

We are of the view that the debt sustainability analysis makes a convincing case for setting the net present value of debt-to-exports target closer to 200 percent.

I wish the best to Ethiopia, especially in its effort to find a peaceful solution with its neighbor in the border dispute.

Mr. Zoccali made the following statement:

It is hoped that the ongoing mediation will produce a peaceful resolution of the border dispute with Eritrea to ensure that the authorities' attention—and scarce budgetary resources—are not diverted from programs critical to its adjustment and development efforts. Important progress has nevertheless been made on the macroeconomic and structural fronts in the context of the policy framework supported by a second annual ESAF arrangement.

The staff's preliminary HIPC Initiative document and Mr. Morais's presentation make abundantly clear the unsustainability of Ethiopia's debt burden in absolute terms as well as in relation to other HIPC Initiative eligible countries. Ethiopia's plight is compounded by the economy's pronounced vulnerability to negative external shocks, in particular those affecting its coffee exports or official transfers, given its reliance on coffee exports, low tax revenues, and large primary fiscal imbalance. We can therefore agree with the staff's suggested target NPV of debt to exports ratio at the lower end of the 200-220 percent range, preferably 200 percent, accompanied by a non-binding debt service ratio target of 20 percent.

The implicit debt relief, subject to Ethiopia's fulfilling the conditions for reaching the decision point, offers reasonable assurances of a strong and consistent adjustment effort to consolidate macroeconomic stability and improve prospects for stronger economic growth. Meanwhile, given that Ethiopia's social indicators are the weakest among the least developed countries, this chair would be sympathetic to some shortening of the interval to the completion point, predicated on a demonstration of overperformance regarding the pace of structural reforms. I subscribe to the comments of Mr. Pickford and others, emphasizing only the importance of improving the quality and effectiveness of public expenditure devoted to primary education, preventive health care, and rural infrastructure.

The approval of the successor ESAF arrangement would seem to offer a suitable vantage point for deciding whether the completion point should be brought forward to underpin a process of sustainable development in Ethiopia.

Mr. Fujii made the following statement:

I will briefly express our views on the issues for discussion.

First, I support Ethiopia's eligibility for debt relief under the HIPC Initiative. Given its severe poverty and heavy, unsustainable external debt burden—accumulated under the old regime—Ethiopia clearly needs to benefit from the HIPC Initiative as soon as possible in order to proceed toward poverty elimination and sustainable growth. To this end, we recently welcomed the second-annual ESAF-supported program as an important step, and I would like to emphasize that Ethiopia should continue to demonstrate its firm commitment to the implementation of strong and sufficiently prolonged economic reform.

Second, on the decision point, I share Mr. Faini's concern, and I wonder whether the staff's proposal to set the decision point at the mid-term review of the second-annual ESAF-supported program is in line with the framework of the HIPC Initiative. As explained in the staff paper, only the first two years of the SAT program can be included as part of a strong track record. In addition, the first annual ESAF arrangement expired last year due to policy slippages in monetary, external, and structural areas. Misreporting of important transactions by the authorities also hurt the credibility of their commitment to the program. In order to ensure the authorities' strong commitment and restore their credibility, in our view monitoring of policy performance during a full-year ESAF-supported program is at least necessary. Moreover, as many directors pointed out at the recent discussions on the ESAF-supported program, further significant progress on the structural front, including in the financial sector, needs to be achieved before reaching the decision point. Against these considerations, I think that the decision point should be set at the starting time of the third-annual ESAF-supported program.

Third, regarding the completion point, I can support the staff's proposal.

Finally, concerning the debt sustainability target, the vulnerability of Ethiopia is largely similar to that of Burkina Faso, as shown in Table 14. Taking this into account, I think it would be appropriate to set a target of at least 205 percent, in order to ensure fair treatment among HIPC Initiative countries.

Mr. Mozhin made the following statement:

We share the staff's view that Ethiopia is eligible for assistance under the HIPC Initiative. We are also in broad agreement with the conclusions and underlying assumptions of the debt sustainability analysis. As for the level of assistance, Ethiopia is highly vulnerable to terms of trade shocks and changes in weather conditions, owing to its dependency on coffee exports. Therefore, we support setting the target NPV debt to exports ratio toward the lower end of the 200-220 percent range.

Our position on the decision point under the HIPC Initiative will remain conditional upon the achievement of a mutually-acceptable debt rescheduling agreement. Efforts to resolve the bilateral debt problem have recently intensified, which could be a sign of goodwill on both sides. We would therefore be prepared to agree to a tentative decision point in spring 1999. The completion point should be set for three years after the decision point, provided that the Fund program remains on track.

Mr. Schaad made the following statement:

This Chair has already voiced its concern over the current border conflict with Eritrea and I will thus not go any further into this issue. I do, however, share the concerns Ms. Turner-Huggins and others have expressed and would like to encourage the authorities to find a peaceful settlement as rapidly as possible.

It is fair to say that the Ethiopian authorities have made substantial reform efforts in the years following the civil war. However, economic performance has been mixed since the end of 1996, especially as the staff and the Ethiopian authorities were not able to reach understandings on a policy framework for 1997/1998 to bring the program back on track and the first annual ESAF arrangement was allowed to expire in October 1997.

Turning to some technical aspects of the debt sustainability analysis, I would like to express my concerns regarding some pretty optimistic assumptions behind the baseline scenario. Specifically, I think the assumptions on annual growth (7 percent per year for each of the next 10 years), non-coffee export growth (9 percent per year on average), and concessional financing projections are on the high side. In view of the heavy reliance on a single commodity (coffee), this optimistic scenario critically depends on the evolution of international coffee prices and on official and private sector inflows. As such, it remains subject to considerable downside risks.

This being said, I agree with the general message of the debt sustainability analysis. Ethiopia faces an unsustainable debt burden and qualifies for eligibility under the Initiative. However, in light of my previous comments, and taking into account the criteria applied for other HIPC Initiative countries, I would like to propose a decision point no earlier than end of 1999. This would allow a genuine track record of the renewed commitment of the authorities through a full year of program implementation. I am convinced this is important for the credibility and sustainability of assistance under the HIPC Initiative.

As to the completion point, setting it three years after the decision point would provide the authorities with the necessary time to implement the envisaged reforms to ensure that the institutional and logistic structures for an efficient debt management are in place.

Ethiopia's vulnerability is about average compared with the other HIPC Initiative cases. But it is one of the poorest countries of the reference group. As regards the proposed target range for debt sustainability, I agree with the staff that a target NPV of debt-to-exports ratio toward the lower end of the 200-220 percent is justified.

In conclusion, I fully support and encourage the authorities to implement the initiated reform agenda at a brisk pace. I consider Ethiopia eligible under the HIPC Initiative and wish it every success.

Ms. Lissakers made the following statement:

Today's discussion of the HIPC Initiative is preliminary. We need to return to reassess the situation in the spring, when we discuss the final document. The uncertainty related to the border dispute represents the greatest risk to macroeconomic prospects and meeting development priorities. Peace is the first prerequisite for economic progress, and the success of the ESAF-supported program and the prospects for the HIPC Initiative will depend on a resolution of the current situation.

We take seriously the authorities' commitments to hold down military expenditures and ensure full transparency of the defense budget. We need to carefully monitor military expenditures and keep these issues in mind as we move forward toward the final decisions.

It is clear that Ethiopia is eligible for multilateral debt relief, both in *terms of its need and the reforms it has undertaken. Ethiopia has an* unsustainable debt burden and remains vulnerable to changes in weather and commodity prices, even with the successful diversification of its export base. The country has seen important reforms since 1992, under both SAL and IDA, in stabilizing macroeconomic conditions, liberalizing prices, reducing trade barriers, and turning the focus away from nonproductive expenditures toward priority expenditures. The lapse in the first year of the ESAF-supported program was unfortunate, but the restarting of the ESAF-supported program is welcome and it provides a framework for further progress. Recent reforms, including the liberalizing of interest rates and exchange markets and the opening up of the energy and telecommunications sectors to investment, are steps in the right direction, but there is still a long way go.

We support the staff's recommendations on the decision point linked to the mid-term review, with the completion point three years later, and the target NPV of debt-to-exports ratio at the lower end of the 200 to 220 percent range. Given the extreme vulnerability and poverty of Ethiopia, we would prefer a target of 200 percent. Ethiopia's program will provide an important focus for the authorities' efforts to improve financial management, liberalize trade, and improve the environment for private investment. The program reflects the authorities' cautious approach to reform. The acceleration of reforms, including the reduction of trade barriers, banking reform, privatization, and opening up to foreign investment, including foreign banks, can strengthen the performance of the banking system and improve its efficiency in terms of delivering financial services to the economy. This would provide the strongest basis for early progress in addressing Ethiopia's development priorities. We also agree with the point made by the U.K. chair regarding the importance of greater specificity in terms of the time-line for actions.

I reiterate that this is still a preliminary discussion of the HIPC Initiative.

Mr. Houtman made the following statement:

Two weeks ago we supported the Ethiopian request for a second annual arrangement, in view of Ethiopia's good track record in servicing its debt obligations and good economic results under the ESAF-supported program before the last program broke down. More efforts to reform the financial sector and the exchange system, as well as speedier privatization, would be necessary and it is our opinion that the second annual arrangement under the ESAF-supported program provided only a first step for that.

However, to the extent that there is still a possibility of a renewed escalation of the conflict, this might obstruct the reforms and let the ESAF-supported program go off track again, even though the government has indicated a strong sense of ownership of the program. Needless to say, that would unfavorably influence the efforts required under the Initiative. The staff has mentioned assurances by the Ethiopian government that any excess in defense spending would be met by extraordinary resources or expenditure cuts in non-priority areas. I think it is important to have some clarity where these resources will come from and which areas are to be considered as non-priority? In my view, in any case, these cuts will be to the detriment of the necessary developmental efforts in Ethiopia. Also, would it be possible for the staff to elaborate on the measures and procedures envisaged to ensure that both the ESAF-supported program and the HIPC Initiative resources be used towards their predetermined ends?

With respect to Ethiopia's eligibility under the HIPC Initiative, it is clear from the debt sustainability analysis that Ethiopia's debt situation is unsustainable and will remain so well beyond the possible completion point. Also, the low level of per capita income is likely to persist in the coming decades. Ethiopia could thus qualify for assistance under the HIPC Initiative. In this respect, I fully support the staff's assessment. However, on the issue of the proposed timing of the discussion on the decision point in the spring of 1999, I have some hesitations. I point to the fact that the three-year ESAF arrangement that Ethiopia entered into in October 1996 got off-track in the first year already. Although an agreement has been reached on a three-year adjustment framework in spring 1998, I feel that Ethiopia's economic track record is not as steady as could be wished for. Therefore, a somewhat longer period of satisfactory economic performance would have been desirable, before taking a final decision on eligibility. As has been stated previously, the still insecure political and economic situation also calls for some additional time to lapse prior to reaching the decision point. In this light, I would not favor Mr. Pickford's proposal to bring forward the completion point by some six months, which would have the opposite effect of further shortening the country's performance record. A reduction of the interim period for Ethiopia does not seem justified. I acknowledge, however, that the question in how far these timing issues form an incentive for strong program implementation, is a matter of judgement. Therefore, if the Board can form a consensus on the staff proposal, I can go along with it.

On the debt sustainability target, I think that in due course a target NPV of debt-to-exports ratio toward the lower end of the 200-220 percent range is justified.

As a last remark, this Chair would like to reiterate its position that it would be financially irresponsible, also towards prospective candidates, to continue the implementation of the HIPC Initiative without securing sufficient and final financing.

Mr. Goffinet made the following statement:

Ethiopia's macroeconomic situation was already discussed during the Board's recent meeting on the request for a second arrangement under the ESAF-supported program, so there is not need to revisit these issues.

I agree with the staff as an IDA-only, ESAF-eligible country, Ethiopia is *eligible under the HIPC Initiative. And though its track record for the last three* years is not outstanding, the authorities have nonetheless maintained steady progress towards macroeconomic stability and structural reforms. I am especially impressed by the authorities' determination to continue their economic adjustment program, and thus can agree on a preliminary basis that we should consider the final HIPC Initiative decision point document after the successful mid-term review of the second annual ESAF-supported program, i.e. in about six months. I agree with the conditions to be met before reaching the completion point. To give the authorities enough time to finish their structural reform program, it seems, at least on a preliminary basis, reasonable to set the completion point three years after the decision point.

Given Ethiopia's external vulnerability and the need to provide resources to social sectors and other priority spending, I can also tentatively agree that the NPV debt-to-export ratio should be set at the lower end of the 200-220 percent range.

I wish the authorities all the best in their difficult task.

Mr. Schmalzriedt made the following statement:

We consider Ethiopia eligible for assistance under the HIPC Initiative. The debt sustainability analysis clearly indicates that the country's debt situation is unsustainable.

In light of Ethiopia's mixed track record, the decision point suggested by the staff appears to be somewhat early, and I sympathize with those who have called for a somewhat later one. Howeber, despite the failure of the first annual ESAF arrangement in 1996, the authorities remain committed to securing the stability gains achieved so far. We can therefore agree with the suggested decision point in spring 1999, linked to the mid-term review. We also agree with the staff's recommendation that the completion point should be reached three years after the decision point, and that the target NPV debt to exports ratio should be set toward the lower end of the suggested range of 200 to 220 percent.

Ms. Chen made the following statement:

We feel that Ethiopia is eligible for debt relief under the Initiative, taking into account that her debt burden indicators are among the highest of all HIPC Initiative cases. The government has a strong ownership of the Fund-supported economic and fiscal program for 1998-99, and it has been implementing adjustment efforts over the past several years. We emphasize the need for the government to proceed quickly and forcefully with the macroeconomic adjustment and the structural reforms envisaged in the program.

We concur with the staff that Ethiopia fulfills the conditions for reaching a decision point after the satisfactory conclusion of the midterm reviews of the second Annual ESAF Arrangement in April of 1999. Additionally, we support an earlier completion point, occurring by the end of June 2001, as Mr. de Morais requests in his preliminary statement, under the assumption that all prior actions will be completed.

With regard to the debt sustainability target, we think that the 200 percent proposed would be appropriate.

Mr. Rouai made the following statement:

I concur with the staff's conclusion that Ethiopia fulfills the criteria for eligibility to the HIPC Initiative. Ethiopia confronts an unsustainable debt situation and, according to the DSA, this situation will remain, even after the possible completion point. I hope therefore that the authorities benefit from the catalytic role of the HIPC Initiative in enhancing growth prospects, deepening structural reforms, and improving social indicators.

I support the decision point at the time of the midterm review of the second annual ESAF arrangement in the spring of 1999. By that time, Ethiopia will have demonstrated enough commitment to reinforce its track record of adjustment and reforms, which I consider satisfactory despite the lapse of the first ESAF arrangement. Regarding the completion point, I see great benefit in early debt relief and can support Mr. Morais's call for a shortening of the three-year period, provided that the authorities sustain and reinforce their adjustment efforts. Moreover, I support the authorities' view that the target for NPV debt to exports should be set at 200 percent in order to provide the country with maximum assistance in view of its high vulnerability to external shocks and weather conditions and its dependence on a single export commodity.

Mr. Nguyen made the following statement:

We would like to thank the staff for their logical assessment of Ethiopia's eligibility in their Preliminary Document on the Initiative for the Heavily Indebted Poor Countries (HIPC). The eligibility is based on the fact that Ethiopia is an IDA-only and ESAF-eligible country that has demonstrated an appropriate track record of adjustment over at least three years and that, after the full application of traditional debt-relief mechanisms, is expected to face an unsustainable debt burden at the completion point.

Ethiopia's per capita GNP of US$110 is one-fourth the average for sub-Saharan Africa and just about the lowest in the world. Pervasive poverty is reflected in the highest evidence of malnutrition and the lowest primary school enrollment in the world. Severe infrastructural shortcomings contribute to the isolation and vulnerability of the poor, particularly in drought years. Such circumstances call for international community's stronger financial support for Ethiopia.

It is interesting to recall that IDA approved an Emergency Recovery and Reconstruction Project in March 1992 to support the Ethiopian Government's strategy to rebuild and reform the economy. This project was followed by an *IDA Structural Adjustment Credit (SAC) in June 1993. All of the objectives* under the SAC were met or exceeded. On the other hand, the Fund approved a Structural Adjustment Facility in October 1992 to assist Ethiopia's three-year program. Performance under this program was generally good in 1992/93 and 1993/94 and, for the most part, in 1994/95. Most of the program's structural benchmarks were fully met. In October 1996, the Fund endorsed an ESAF arrangement in support of another medium-term program with the aim of achieving further progress in stabilizing and deregulating the economy and improving the prospects of debt sustainability. This fact shows that Ethiopia has shown an appropriate track record of adjustment over the past several years.

The baseline assumptions given in the staff paper shows that Ethiopia is expected to face an unsustainable debt burden even after the full application of traditional debt-relief mechanisms. Moreover, as pointed out by the staff, Ethiopia has typically been heavily reliant on coffee exports and its GDP can be adversely affected by even moderate declines in export volumes, which fluctuate adversely owing to weather conditions. It will takes years for Ethiopia to reduce the reliance on coffee through efforts to diversify exports, requiring intensive upgrading of human resources and physical infrastructure, and modernization of the industrial base. These assessments by the staff give merit to the proposal that Ethiopia is eligible under the HIPC Initiative.

In order to help maintain the momentum of the economic developments and the reform process of the Transitional Government over the last seven years, we have no problem to go along with the Ethiopian government's proposal to consider an early decision point, probably following the conclusion of the mid-term review of the second year ESAF-supported program in the spring of 1999, and the setting of the NPV debt-to-exports ratio toward the lower end of the 200-220 percent range. We also support the recommendation that the completion point should be reached three years after the decision point.

In conclusion, we would like to stress that the Ethiopian government should spare no efforts to maintain the track records to win full support from the two Boards for assistance under the HIPC Initiative with the ultimate goal of eternal exit from the heavy debt burden. We wish the authorities every success in dealing with challenges ahead.

Mr. González Sánchez made the following statement:

During the last few years, Ethiopia has made remarkable progress concerning adjustment policies and structural reform. The results of the policies adopted can be appreciated by the recent economic performance: GDP growing at rates above 5 percent in the last three years, declining inflation, and a current account deficit (including official transfers) of around 3.7 percent of GDP. In 1997/98, however, output growth is estimated to slow considerably owing to the adverse effects of El Niño on the agricultural and transportation sectors. Fortunately, inflation has been contained, as a result of a relatively tight monetary stance and abundant food availability

The adverse climate conditions are only one of the unfavorable factors faced by Ethiopia in recent years. The border conflict with Eritrea is another. Therefore, the efforts made by the Ethiopian authorities to transform their economy in the middle of a hostile environment must be praised.

In spite of the positive recent developments, Ethiopia remains a poor country. Indeed, with a GNP per capita of US$110 in 1997 and with about 80 percent of the country's population living on less than US$1 per day, Ethiopia is at present one of the poorest countries in the world. The civil war ending in 1991 had very adverse effects on infrastructure and the provision of basic social services. This, combined with the economic mismanagement under the previous regime's central planning, resulted in devastating effects on the productive capacity of the economy. On the other hand, Ethiopia's external debt, at an estimated 158 percent of GDP at end-June 1998, represents a very heavy burden that complicates substantially the evolution of the economy.

In this context, I consider Ethiopia eligible for assistance under the HIPC Initiative. While it is true that substantial progress has been made since the start of the country's economic reform process in 1992, additional macroeconomic adjustment and structural reforms are needed to establish strong foundations for growth. The debt relief available under the HIPC Initiative would permit a decline of the country's debt burden to more manageable levels, as well as vital resources for the authorities to provide basic services to the population and build infrastructure. The importance of expenditures in health, education and infrastructure cannot be overemphasized, since investment in both physical and human capital, is among the most important pillars for long-term economic development.

Concerning the decision point, I agree with the staff's suggestion to consider a final HIPC Initiative Decision Point document following the conclusion of the mid-term review of the second year ESAF-supported program expected in the spring of 1999. Similarly, I agree with the staff's recommendation that the completion point should be reached three years after the decision point. Finally, I agree with the staff that the NPV debt-to-export ratio be set at the lower end of the 200-220 percent range.

Mr. Palmason made the following statement:

Taking account of the debt level and the track record, we can agree with the staff to consider Ethiopia eligible for HIPC Initiative assistance.

It would be appropriate to consider a final decision point in the spring of 1999 following a satisfactory conclusion of the mid-term ESAF-supported program review.

As the staff suggests, and as the rules prescribe, we prefer the length of the interim period to be three years. However, we do not exclude that this proposal could be reconsidered during the spring of 1999, when the two Boards discuss the final HIPC Initiative Decision Point document.

The staff should closely monitor economic developments in Ethiopia and the authorities' compliance with program conditions. It must be ensured that resources freed by debt relief are not channeled into military spending.

On the debt sustainability target, we agree with the staff recommendation that the NPV debt-to-export ratio could be set toward the lower end of the 200-220 percent range in view of Ethiopia's external vulnerabilities.

Mr. Al-Turki made the following statement:

In view of Ethiopia's unsustainable debt burden and vulnerability to external shocks, I fully agree that it is eligible for assistance under the HIPC Initiative. I support the staff's recommendation of a decision point following the conclusion of the mid-term review of the second year ESAF-supported program, in spring 1999. I support the shortening of the completion date to June 2001. With regard to the debt sustainability target, I support the recommendation that the NPV debt to export ratio be set at the lower end of the 200 to 220 percentage range.

Mr. Qi made the following statement:

This chair agrees that Ethiopia is eligible for assistance under the HIPC Initiative.

On the decision point, it seems quite reasonable to set the decision point in the spring of 1999 following the conclusion of the mid-term review of the second annual ESAF-supported program, as explained by the staff at the beginning of the meeting. On the completion point, although I agree that sufficient time should be left for the authorities to implement structural reforms, it seems to me that an earlier debt relief for the country could help the authorities build domestic support for the reform measures. I, therefore tend to support the suggestion made by Mr. Pickford and others that we should shorten the interim period to two and a half years.

On the debt sustainability target, I support the view that the NPV debt to exports ratio should be set at 200 percent.

Mr. Jadhav made the following statement:

Our Chair would like to reiterate what we had stated in our preliminary statement.

We consider Ethiopia to be eligible for assistance under the HIPC Initiative.

We are in favor of advancing the decision point, if the performance of Ethiopian economy in the first year of the ESAF-supported program is fully up to the mark.

Going by the staff recommendation that the completion point should be reached 3 years after the decision point, the completion point would be reached approximately 5 years from now. In our view, that is too long a period to keep a country waiting. We would strongly urge that the completion point be brought forward. We are fully sympathetic to the proposals made by Mr. Morais and Mr. Pickford.

Finally, we agree with the staff that NPV debt to export ratio could be at the lower end of the 200-220 percent range.

The Deputy Director of the African Department said that during the period from 1995 to 1997, Ethiopia was within the top five African countries in terms of growth performance and had stronger inflation performance than any other country. The ESA-supported program growth targets were well exceeded and inflation targets were over-performed. The foreign reserve position of the country was also at a high level. The country's macroeconomic framework was maintained in a cautious and prudent manner. Some of the foreign asset credit targets were not met toward the end of 1997-1998, however. That was not the result of pervasive mismanagement of the economy but largely due to one single special transaction involving Ethiopian Airlines. The reserve level had also declined as a result of the conflict with Eritrea; but had there been no border dispute, the reserves would have been at the same position as in previous years.

The staff believed that there was a sufficient case for a spring 1999 decision point, the Deputy Director commented. The Board had approved a strategy for moving forward on Ethiopia's program two weeks earlier. By the time of the mid-term review, Directors would be able to evaluate Ethiopia's performance during the six months leading up to the mid-term review.

Regarding shortening the period between the decision point and the completion point, the staff would work within the existing framework to accelerate the process with the authorities, the Deputy Director suggested. However, there were risks associated with speeding up trade liberalization. The staff had provided extensive fiscal technical assistance to

Ethiopia and had ultimately suggested that the tariffs had been sufficiently lowered—to about 12 percent—and that further tariff reductions could reduce trade tax revenues too much. Furthermore, the pace of trade liberalization should be linked to actions on domestic taxes and alternative tax sources. The staff was working with the authorities on reforming the excise tax, sales tax, and eventually income taxes, as well as the value-added tax. It was important to focus not just on implementation but also on the tax administration side, and on how quickly the measures could be put into place. The authorities were committed to making sure that the trade taxes would be brought down as long as alternative tax sources could be efficiently put into place.

There was a basic framework for protecting expenditures in priority areas, the Deputy Director reported. Spending was classified by different social sectors, functional categories, and economic categories. Public expenditure reviews and the Fund's mid-term review would monitor spending on the social sectors. The authorities had made it clear that if they were pushed to spend more money on defense, they would try to come up with extraordinary measures to pay for it. The staff would keep in mind Directors' comments that cutbacks in nonpriority expenditures could hurt growth and social sectors, and would try to avoid such problems.

The staff had been reasonably conservative in its export projections in areas such as coffee prices and volumes, the Deputy Director noted. Coffee prices were projected rise to about $120 per tonne, which was what the World Economic Outlook had predicted. The figures on coffee volumes showed an upward trend owing to new coffee trees, better extension services, improved infrastructure, and rising productivity. More washed coffee would also mean a higher average price for coffee. Moreover, non-coffee exports had risen substantially in recent years under the reform, from $120-million in 1993-94, to $249 million in 1996-97. The general strategy of 9 percent growth in the volume of non-coffee exports would likely be accomplished. Ethiopia led the 44 countries in the African Department in terms of its growth, inflation rate, and export performance. It was important to move forward with caution and prudent structural policies, however. The same caution should be—and had already been—exercised on the macroeconomic side.

The staff representative from the African Department said that the projections regarding Ethiopia looked relatively attainable. The country was starting from such a low level following the destructive civil conflict that it had quite a good chance of continuing to achieve high growth, which would be underpinned by the ambitious structural reforms in the program. The government had no option but to impose such a stringent growth target. Starting with its current per capita income of only $110, even with rapid growth Ethiopia would nevertheless still be relatively poor in 20 years. Moreover, the levels of concessional borrowing would also be predicated on strong performance. If the government carried out all of the reforms, growth was rapid, and the economy was privatized, for instance, then Ethiopia would be on firm ground to request external assistance.

The staff representative from the Policy Development and Review Department said that a member country was expected to have a track record of six years or more of strong and sustainable policy performance by the completion point. However, the required period could be evaluated flexibly. Member countries could receive credit toward the period leading up to the decision point for programs that were underway prior to the adoption of the HIPC Initiative. That had already been done in the case of Ethiopia. A reasonable shortening of the second stage could be considered on a exceptional basis for member countries that already had a sustained record of strong performance. The first such cases that had come to the Board, including Uganda, Bolivia, and Mozambique, had long track records of strong and sustained performance. However, a three-year second stage was expected to be the standard in the future, and would be proposed for most cases, including Cote D'Ivoire, for example, despite the fact that it had a strong track record too.

Mr. Morais made the following statement:

Directors have once again shown keen interest in Ethiopia. I will relate to the authorities the views that have been expressed. I would like to reassure Directors that the Ethiopian authorities will comply with their obligations as a debtor country, and will therefore make all efforts necessary to conclude negotiations with its creditors, particularly the Russian Federation.

There seems to be broad agreement that debt relief is important for Ethiopia. The authorities are aware of this and are committed to fully implementing their reform program. However, today's discussion highlighted the need for the Board to undertake a comprehensive review of the HIPC Initiative. Should we favor the quality of reforms, or should we continue to stick to the length of the adjustment programs, requiring debtor countries to adhere to two consecutive ESAF arrangements before getting relief? The strengthening of Ethiopia's reform effort should support an early completion point. There seems to be broad support for the sustainability target to be set at, or close to, 200 percent. Most Directors have referred to the border conflict as a risk to the program's implementation. My authorities agree that peace and stability are crucial to economic growth and development and have indicated their commitment to finding a solution to this problem. The authorities share the Board's view on the importance of moving forward with the reform process. The ESAF-supported program remains on track, and the authorities intend to stay on course.

The Acting Chairman made the following summing up:

In discussing the preliminary document for Ethiopia under the HIPC Initiative, Directors agreed that Ethiopia should be eligible for assistance under the initiative, in view of its high level of indebtedness and external vulnerability. They also noted that Ethiopia is one of the poorest countries in the world, with its social indicators among the weakest in sub-Saharan Africa, and the fact that it is an ESAF-eligible and IDA-only country. As regards the track record of Ethiopia, Directors considered that the country had demonstrated generally sound performance in implementing macroeconomic and structural reforms under the SAF arrangement during the period 1992/93-1994/95. However, a number of Directors expressed concern about slippages in the first year of the current three-year ESAF arrangement approved in October 1996 and the delays in reaching agreement on a follow-up program, but welcomed Ethiopia's strong commitment to the program now agreed and supported by the Fund under the second annual ESAF arrangement.

With respect to the decision point, most Directors agreed that it could be reached at the time of the completion of the mid-term review under the second annual ESAF arrangement for Ethiopia, expected in the spring of 1999. A few other Directors, however, favored a decision point at the time of Board approval of the third annual ESAF arrangement, which is expected in the fall of 1999. Many Directors also stressed that the completion point should be set three years after the decision point, given the need to forcefully implement further substantial economic reforms. Several other Directors were willing to consider a somewhat shorter second stage—with a completion point in fall of 2001—noting that earlier debt relief would contribute to a strengthening of private sector confidence and help build domestic support for deeper reform. Such a shortening would, however, be contingent on a clear demonstration of strong implementation of reform measures by the authorities. Directors called on the authorities to accelerate the debt reconciliation with all of Ethiopia's creditors, before the decision point can be reached.

In view of the slippages under the first annual ESAF arrangement, Directors stressed that performance under the new ESAF-supported program *would need to be strong, and they saw the need for an acceleration of structural* reforms in key areas. They welcomed the steps that had been taken already to make operational the interbank foreign exchange and money markets, and to liberalize further the making of payments for current international transactions. Over the coming months, they urged the Ethiopian authorities to take swift actions to undertake further tariff reform and implement offsetting domestic revenue measures, to privatize a number of state-owned enterprises, and to strengthen banking sector reform. Directors noted, however, that strong performance under the program could only be ensured with a quick and peaceful resolution of the current border dispute with Eritrea. On this matter, they welcomed Ethiopia's cooperation in the current peace effort led by the Organization of African Unity and stressed that it is imperative for Ethiopia to safeguard the overall fiscal objectives, including spending on social sectors, from expenditures arising from the dispute.

Directors generally supported the staff's recommendation of a target for the net present value of debt-to-exports ratio toward the lower end of the 200-220 percent range—and several preferred a target of 200 percent—because of the high vulnerability arising from the concentration of Ethiopia's exports.

Directors noted that, according to current projections, proportional burden sharing would require the Paris Club and other bilateral creditors to provide debt relief equivalent to around 80 percent of the net present value of eligible debt.

Regarding the next steps, Directors indicated that the staffs of the Fund and the Bank should proceed with substantive consultations with Ethiopia's other creditors, including the Paris Club and other multilateral creditors, and with the preparation of a final HIPC Initiative decision point document.

3. INDONESIA—REVIEW UNDER EXTENDED ARRANGEMENT; AND EXCHANGE SYSTEM

The Executive Directors considered a staff paper on the second review under the Extended Arrangement for Indonesia (EBS/98/174, 10/19/98; and Sup. 1, 10/23/98).

The Director of the Asia and Pacific Department made the following statement:

> During the past two weeks, since the staff report was issued, the encouraging trends toward a gradual improvement in macroeconomic developments have been generally confirmed. The fall in GDP growth in the third quarter was considerably less than in the previous two quarters; it was 9 percent in the first and the second quarters, and only 2 percent in the third quarter. Inflation has moderated significantly. In fact, the change in the price index in October, compared to September, was slightly negative (minus 0.3 percent). That primarily reflects the stabilization of rice prices. Although the rice situation has improved, the authorities need to ensure that there are sufficient rice imports, which may require an expansion in the subsidized rice scheme. The prices of other basic commodities and foodstuffs have also been declining. Therefore, we do not expect a serious pick-up in inflation over the next few months. The estimates for price increase of 80 percent during 1998 will be more or less reached. Also, the estimate for a 15 percent decline in GDP growth will be reached. These estimates were prepared after the riots last May, and have not changed significantly since then.
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> Base money has stayed within the program path. Monetary policy continues to be closely observed by the Monitoring Committee and is being implemented smoothly. Reserves are holding up. In fact, they have increased by $1½ billion since the last review. Interest rates have continued to decline significantly. The overnight rate is currently at 54 percent, compared to 67 percent during the previous review.
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> The stock market has increased by 29 percent since the last review, which is remarkable. Also, the exchange rate has continued to appreciate, although during the past few days it has been quite volatile. This may have something to do with the postponement of the Board meeting, but, more importantly, with the heightened political nervousness prior to the special session of parliament. Today, the rupiah closed at 8,450 per U.S. dollar, which is 28 percent above the level it was during the last review meeting.
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> On the political situation, the special session of parliament will take place during November 10 to 13, 1998. That event is, of course, dominating the political climate. The agenda includes decisions on laws to establish political parties, election laws, and will set the election date. Draft laws are already before parliament. The suggested election date is May or June 1999. The agenda does not include discussions on changing the President. Nevertheless, there have been agitations by opposing groups, either to unseat the President or to support the President. That has contributed to a somewhat tense atmosphere. The consensus in Jakarta is that there should be no major problems during the

special session, and that after the special session, the business climate should improve further.

On bank restructuring, which was the reason for the postponement of the Board meeting, the settlement of liquidity support that Bank Indonesia gave to the banks is an important element in the process of bank restructuring. For this reason, this was made a prior action for this review. In paragraph 16 of the letter of intent, it states that the authorities expect that agreement with the first two or three banks would be completed by October 29, 1998, which was the day before the previously scheduled Board meeting. However, the negotiations have proven to be quite difficult. The amounts for the first three banks are large—about $9 billion or 7 percent of GDP. The modalities of how to settle these debts immediately became a political issue. For the purpose of the economic program, these agreements must be economically and commercially sound, and they must also be durable. That means that their legal underpinning must be safe. By economically and commercially sound, we mean that the government will attempt to obtain the maximum value from the settlement and also that the debtors will retain their freedom to pursue restructuring plans. In judging this process, the staff had to rely to a considerable extent on the use of outside independent experts; in particular, experts from Lehman Brothers and experts from [Treuhand] in Germany. We only learned this morning that satisfactory agreements with the first three banks have been concluded and have been signed today.

The restructuring process entails shareholders turning over assets which they own to a holding company. The holding company then sells these assets over a period of three years. The cash generated is used to repay the government, and goes into the budget. It was further agreed that during the first year, 27 percent of the total cash should be generated. The agreement is regarded as satisfactory by IBRA, the bank restructuring agency, and the shareholders of the three banks. The technical advisors have certified that these are durable and meaningful agreements, and the legal counsel to IBRA has also certified that the legal basis is sound. Thus, the prior action under paragraph 16 in the letter of intent can be regarded as being fulfilled. This agreement opens the way for further progress in bank restructuring, and it also clears the way for the rehabilitation of these companies, the shares of which are to be turned over to the holding company.

Mr. Harinowo, speaking on behalf of Mr. Zamani, made the following statement:

The Indonesian authorities wish to convey to the Board the latest actions undertaken to expeditiously set Indonesia on a firmer path of economic recovery. Since the last Executive Board meeting, we have witnessed considerable progress in Indonesia's economic development especially in the implementation of their economic program. The authorities have reiterated their full commitment in adhering to the policy framework under the Extended Arrangement, a commitment designed to quickly restore confidence in the Indonesian economy.

On recent economic developments, encouraging improvements have been apparent on many fronts. Steady progress on economic stability has been achieved. The rupiah exchange rate continued to strengthen significantly from a level of Rp. 10,700 at end-September to Rp. 7,500 per U.S. dollar on October 26, 1998. Among the factors contributing to this are the authorities' strict adherence to "strong monetary discipline" and improved market sentiment concerning regional currencies following the strengthening of the yen against the US dollar. Moreover, the agreement between the Indonesian government and the Paris Club creditors reached in Paris on September 23, and the framework for the resolution of domestic banks' external debt and trade credit through the implementation of the Frankfurt Agreement earlier this year, helped reduce the demand for dollars and thus dampened the pressure on the rupiah exchange rate. Nevertheless, the exchange rate pressure is expected to remain until local corporations with very large overseas debts manage to reschedule their obligations. The authorities also recognize that the value of the rupiah has not been determined purely by economic factors.

On the domestic front, inflationary pressures eased considerably in September; the monthly inflation rate dropped to 3.75 percent, from 6.3 percent in August and 8.6 percent in July. As a result, the January-September inflation rate was 75.5 percent (or 82.4 percent year on year). Despite the increase in food prices which remained the major contributor to the September inflation figure, the inflation rate in September declined markedly due to the improved monetary situation, the disbursement of international aid, and the elimination of monopoly in several basic commodities. The inflow of international rice aid and government imports of rice are expected to help stabilize the prices of food staples further. Moreover, the recent strengthening of the rupiah against the U.S. dollar will help contain any inflationary pressure in the future. In October, there was indications that the price of rice and some other basic commodities had declined in the domestic market, owing to the improved distribution system for essential goods.

As regards monetary condition, the central bank certificate (SBIs) rate has shown a declining pattern eight weeks after the authorities implemented the auction system in the market. The one-month SBI rate fell to 56.18 percent as of October 28, from 71 percent at end-July when the auction system was initiated. In view of the decline in interest rates and the success of the auction system, the authorities initiated monthly sales of three month SBIs on October 14 to lengthen the maturity structure of monetary instruments and strengthen monetary control. The first auction was executed at the rate of 59.82 percent. Concomitant with the declining trend of SBI rates, money market interest rate was lowered to 49.60 percent in the third week of October, from 56.90 percent in September. In parallel, interest rates on bank deposits dropped to an average of 51 percent from around 60 percent over the same period. It should be noted, however, that the decline in interest rates was very gradual to avoid premature easing of monetary policy.

Lately, the Indonesian capital market has also shown signs of improvement. After having dropped to its lowest level of around 250 at the beginning of October, Jakarta's composite stock price index rose to 315 on

October 26. This favorable development was in line with the improvement in stock price indices of major capital markets in the world, following the second reduction of the Fed Funds rate. Furthermore, the strengthening rupiah and a declining trend of domestic interest rates have also exerted positive impacts on the development of the Indonesian stock market.

Turning to fiscal issues, the authorities admitted that development spending was much lower than targeted. Delays in the implementation of some projects were attributed to substantial revisions to the original budget and as a result of its allocation which was approved by Parliament only in July. At the same time, the government was trying to strengthen the system of budgetary controls and monitoring to protect against leakages and corruption. Consequently, progress was somewhat slow in implementing new initiatives in health, education and employment creation. Nevertheless, the authorities are committed to accelerate project implementation in order to stimulate economic growth.

On the external front, both the trade and current account balances registered a surplus in the first half of 1998, due mainly to a continued decline in imports in line with weak domestic demand. The capital account, which has recorded deficits since the fourth quarter of 1997 owing to deteriorating foreign investor confidence, has recently improved substantially and turned into a surplus in the second quarter of 1998. Market confidence in the Indonesian economy has been regained progressively as private foreign capital has started to reflow into the country. However, owing to huge capital outflows in the first quarter of 1998, the capital account in the first half of the year remained in deficit. Overall, the balance of payments recorded a deficit in the first half of 1998 . Net international reserves stood at US$ 13.9 billion, which was still higher than the indicative target for October 1998.

With regard to the issue of capital control, we all have learned a lesson that short term capital inflows can be very volatile and, therefore, should be carefully monitored and checked. Accordingly, a prudential reporting system and external debt management are deemed necessary. In this respect, the authorities are not planning to force exporters to repatriate their foreign exchange earnings, but are instead working on a draft plan to better monitor the movements of foreign exchange.

On financial sector restructuring, a thorough plan has been drawn up to expeditiously rehabilitate ailing banks and strengthen the remaining ones. The authorities announced the details of the re-capitalization program on September 29. The said program will be conducted as follows:

First, in estimating the amount needed for re-capitalization, the financial position of all banks will be reviewed by the authorities and international auditors to determine which banks need to participate in the recapitalization program. In order to be eligible for the government-sponsored recapitalization program, a bank must presently have a capital adequacy ratio (CAR) of better than minus 25 percent, but less than 4 percent of assets. Banks whose CAR is above 4 percent will not be included in the recapitalization program. To date, the financial due diligence has been undertaken for 80 banks and completed for 12 banks. It is expected that the due diligence process for the remaining banks will be completed by end-October 1998. Hopefully, the whole banking recapitalization program could be accomplished by late-December 1998;

Second, a bank which is considered eligible for the recapitalization program will be urged to submit a business plan within one month. The plan is to cover: (a) resolution to its non-performing loan to fulfill the legal lending limit (LLL) requirement; (b) quarterly review of the operation for the next 3 years; and (c) estimation on the fulfillment of all prudential regulations including the concentration credit ratio, corporate restructuring, internal supervision and completing the team work for bad-debt resolution;

Third, banks with an acceptable business plan should pay off liquidity support within a month. Government participation will then be available if it is proven that there will be capital injection in the form of fresh money from the owners or other investors. For each Rp 1 fresh money from the owner or investors, the government will provide Rp 4; and

Fourth, government participation is temporary. After three years, the government will divest its ownership, and the process of divestment should be completed within two years.

In relation to the process of bank restructuring, amendments to the banking law have been approved by Parliament on October 16. This will facilitate the restructuring process by strengthening the legal power of the Indonesian Bank Restructuring Agency (IBRA) and its Asset Management Unit (AMU). In addition, a new central bank law which would institutionalize Bank Indonesia's autonomy has been drafted and is expected to be submitted to Parliament in November 1998.

In conclusion, my authorities would like to convey their sincere gratitude to the Board, the Management and mission staff for their invaluable advice and continued support. The Indonesian authorities remain firm in their commitment to the reforms and policy measures as set out in the latest letter of intent, with a view to restoring economic and financial stability to the domestic economy as expeditiously as possible. To this end, continued support from the international community would not only be helpful but also indispensable to the success of such endeavors.

Extending his remarks, Mr. Harinowo said that when he spoke to the business community during his most recent visit to Indonesia, their mood seemed optimistic. In fact, some members of the business community had indicated that they had transferred the money that they had moved to offshore accounts and put it back into their businesses. Clearly, the situation looked more promising now that the rupiah had strengthened to 10,000 per U.S. dollar. Also, some of the stores and supermarkets that had been burnt or destroyed during the May riots have started to operate again. When he spoke to the farmers in a remote village in West Java, 200 kilometers from Jakarta, they felt that the next year's harvest would be better. Thus, there were many signs that the economy was recovering. To that end, he conveyed his deepest appreciation to the Board, management, and the staff for their support and efforts to make those achievements possible. He also expressed his appreciation to the countries that have lent their support; in particular, the Japanese government, which, in addition to the support it has already given, has recently put together the Miyazawa Initiative.

Ms. Abdelati, speaking on behalf of Mr. Shaalan, made the following statement:

> The Indonesian authorities are to be congratulated for harvesting some of the long- awaited fruits of their efforts, as represented in the significant strengthening of the rupiah in the past four weeks. The firm commitment of the government, and its diligent pursuit of far-reaching ambitious reforms over a short time period, has provided the impetus to restore market confidence in the Indonesian economy and should have beneficial effects on the finance and corporate sectors.
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> Notwithstanding this achievement, it is well to note that the full harvest is not yet assured. The economic situation remains rather somber and the losses and suffering of the Indonesian people will take a long time to recuperate and heal. The staff report succinctly, but comprehensively, makes it amply clear that the situation remains very fragile and that these hard-won gains could easily evaporate. We therefore extend our strong encouragement to the Indonesian authorities to push forward with the reform momentum so far achieved .
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> At this juncture, the resumption of growth is the single most critical challenge facing the authorities. The restoration of market confidence in the rupiah and the stock market will undoubtedly aid this process. In this connection, we welcome the recent interest rate easing which will release some of the pressure on the banking and corporate sectors. However, the continued slippage in government spending will not provide the programmed fiscal stimulus. This is an area of concern, particularly as it comes at the expense of high priority social outlays.
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> With respect to monetary policy, we very much welcome the staff's reasoned advice regarding the gradual easing of interest rates in the last quarter while standing ready to adjust policies in the case of exchange rate weakening or accelerating inflation. At this stage, the obvious question is whether the staff are targeting the same exchange rate of Rp 10,000 per dollar or referring to a weakening from the current rate of around Rp 8,400.
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> The higher-than-anticipated costs of bank restructuring are not altogether surprising in view of the severity of the crisis and the impact of prolonged high real interest rates on banks. As rightly noted by the staff, the interest cost of the bonds to finance restructuring will ultimately depend on how quickly interest rates decline. We are somewhat concerned however by the last minute disagreement regarding the repayment of liquidity support to private banks and hope that holding the Board meeting tomorrow indicates that this issue has been satisfactorily resolved. Staff views on the status of this issue would be appreciated.

We very much welcome the progress made in developing the framework for corporate debt restructuring under the Jakarta Initiative even though the true test of these efforts will be in the implementation. The removal of regulatory impediments on debt to equity conversions and on tax disincentives for restructuring as well as the provision of tax neutrality for mergers are all fundamental steps to pave the way for effective corporate debt restructuring. We look forward to the anticipated regulatory framework for the approval process, which we believe will lend the process a forward push.

We are happy to support the proposed decisions. While the credit for the outcomes so far belongs to the resolute commitment of the authorities, we wish to also extend our appreciation to the dedicated efforts of the staff and wish those of them leaving the Indonesia team equally rewarding ventures in their future assignments.

Mr. Nelmes, speaking on behalf of Mr. Bernes, made the following statement:

Let me start by thanking the staff, particularly for the supplement on Banking Sector Developments. This document provides a very useful chronology of events and developments in this sector. It is disturbing to find out how badly the banking sector was run in Indonesia, and how little the international community knew about it. This underscores the need to conduct comprehensive surveillance of the banking sector in the context of Article IV consultation with Fund members, especially in the emerging economies.

Turning to the Second Review of the EFF, we are encouraged by the progress made to date, and the authorities' continued commitment to the program. We support the proposed decisions. Nevertheless, we have a few concerns.

The Second Review does not include any economic or fiscal projections for the 1999/00 fiscal year, which begins in April. While recognizing the considerable uncertainty about future conditions in Indonesia, we would appreciate receiving the staff's assessment of growth and inflation prospects for 1999/00. I would note that whereas the staff projects that Indonesia will post a current account surplus equal to 1.6 percent of GDP in 1998/99, the private sector consensus is for a surplus exceeding 7 percent of GDP.

We continue to be concerned about the under performance on budget spending. Under current circumstances, the Government of Indonesia should help ease the pain of adjustment through targeted social spending, and stimulate economic activity through development spending and public infrastructure programs. We call on the Government of Indonesia to rapidly raise budget spending to the targeted level.

It is difficult to assess the stance of monetary policy. Interest rates have fallen by over 10 percentage points since early September to just below 60 percent. In light of the recent strengthening of the rupiah and declines in inflation, there may be room to lower interest rates further. Without an inflation forecast for 1999, however, the appropriate current setting for monetary conditions is difficult to ascertain.

Moreover, we would appreciate more discussion about the reasons for the recent strengthening of the rupiah. We wonder whether the appreciation truly reflects market confidence rather than inflows of official assistance. We understand that the central bank and aid agencies are the largest participants in the foreign exchange market. Does the staff believe that recent gains in Asian financial markets, including Indonesian markets, are justified by economic or structural improvements?

The rationale for monitoring capital flows on a daily basis is difficult to understand. Given current heightened attention to capital controls, the daily monitoring of foreign exchange inflows and outflows might raise concerns in the market about the authorities' commitment to maintaining an open capital account. With a floating exchange rate, however, changes in capital flows will be accommodated through movements in the exchange rate, and the authorities need not be concerned with day-to-day fluctuations in capital flows. Furthermore, daily monitoring would impose a significant reporting burden. Could the staff explain the rationale for daily monitoring?

The staff expresses concerns about the Government's preference to sell assets acquired by the IBRA over a relatively short period. We disagree with the staff's suggestion that asset sales be delayed until market conditions improve. Asset sales are an important means of restoring investor confidence and attracting new capital. In our view, the low price received by the Government for assets sold today will be more than offset by the boost that asset sales give to the economic recovery. We do, however, have concerns about the process for selling assets. The staff should focus on the transparency of the process for selling assets rather than on the timetable. We are concerned about rumors of political interference in the process and about the authorities' 'Indonesia First' policy, which imposes more onerous conditions on foreign buyers of local assets than on Indonesian buyers.

Paragraph 32 of the staff report refers to "shortfalls in multilateral and bilateral foreign financing for the budget so far this year." We were under the impression that the financing gap had been fully covered. Could the staff elaborate on the sources of the shortfalls?

Mr. Sivaraman made the following statement:

It is indeed satisfying to note that Indonesia is now emerging out of its financial troubles and that there is a hope of the crisis bottoming out sooner than later. The strengthening of the Indonesian Rupiah from a level of 17000 to a US dollar which it had touched some time in the month of June 1997 to the current level of below Rupiah 7500 per US dollar is indeed a remarkable achievement of the authorities. It is also a tribute to the efforts of the staff and the management of the Fund who have worked with the authorities to ensure that the policies succeeded.

I will confine myself to some comments and a couple of questions.

It has been mentioned in para 5 of the supplement to the staff memorandum on Economic and Financial Policies that the powers to adjust contracts to reflect changes in costs and price have been devolved to regional administrations. In my view, contracts should not be adjusted as this might give room for disputes and discretionary decisions that could be questioned. Contracts should provide for price adjustment clauses based on proper indices to reflect increase in wages paid to labor and increases in costs of materials and supplies due to inflation. This would avoid exercise of discretionary powers.

Regulation will also allow contractors to be paid 40 percent of the contracted amount as down payment. There is nothing wrong in up-front payment being made to contractors particularly when interest rates are very high but when contracts are awarded, the cost of this fund, if provided interest free, should be taken into account.

The authorities have explained the reasons for less than targeted spending on developmental works and also in implementing programs in the health, education and employment sectors. While the steps taken by the authorities to ensure proper budgetary control and monitoring of expenditure to protect against leakages and corruption are appreciated the longer the delay in the implementation of program the more will be the suffering for the poor who may be wanting employment in government promoted works. Therefore, there is an urgent need to tackle this problem.

On privatization, I fully support the authorities and I am not worried about the delay in disinvestment of shares. Authorities should ensure that there are no fire sales and they are able to get reasonable prices for their investments. It is also a good time to restructure the state enterprises before they are sold as this would enable them to get better returns from the market.

The World Bank note on Rice Security does raise some serious issues like Bulog's inability to maintain the schedule of imports which might endanger food scarcity. Having sufficient food stocks on hand may be a necessary condition of food security but not sufficient as the authorities will have to ensure the availability of purchasing power with the poorest of the society. It is here the need to accelerate Government work programs becomes significant. Organization of productive works where poor people could be usefully employed enabling them to have sufficient wages to purchase the bare essentials of livelihood is not an easy task. It involves very careful planning of work so that large investments in them do not get wasted when once the economy gets back to normalcy. As bulk of the cost for the works would be in the form of wages, there has to be a proper accounting system to ensure that there is no fraud. Even from the very beginning authorities will have to plan how works taken up during this period should be completed when normalcy is restored. These are no doubt issues of micro-level arrangement, but in the end they have a macro impact.

If the Bulog is not in a position to cater adequately to the demands of the public distribution system, alternative means of providing subsidized food grains will have to be explored. For example, part of the wages could be paid in the form of food stamps which people can use to buy from private traders who can encash the food stamps for the subsidy element.

The authorities are concerned about the impact of high interest rates on the banking system including effects of negative spreads between deposit and lending rates. They have stated that this has increased bank and corporate insolvencies and added to costs of bank restructuring and the corporate sector. I had referred to this matter even at the beginning of the program when the staff had replied that high interest costs might definitely lead to more bankruptcies. Would it be possible to indicate how much this would add to the cost of restructuring of the banking and the corporate sectors? I however, agree that there should be only a gradual and cautious easing of interest rates. Mr. Zamani's lucid statement has been helpful in understanding the bank restructuring plans of the authorities.

The staff report refers to the high volume growth in exports but low growth in terms of value on account of sharp decline in prices. The volume growth in exports in my view would be only temporary. With the effects of depreciation getting reflected on the cost of imported inputs the advantage which Indonesia now has of the depreciation in the value of Rupiah would be substantially eroded. Therefore we should not be over-optimistic about export performance. I had earlier requested the staff to do an exercise to forecast trade performance. I am not sure whether staff could look at this issue. At the cost of repeating myself, I would indeed appreciate a response whether this issue merits attention.

With these remarks, I will reiterate that in spite of the tremendous odds which the authorities have been facing, it is a credit to them that they are able to lift the Indonesian economy from the morass into which it had fallen only a few months ago. I support the proposed decisions and I wish the authorities all success.

Ms. Lissakers and Mr. Sobel submitted the following statement:

Indonesia has made further critical progress on the road to recovery over the past month. Important signs are now emerging that economic stability is beginning to take hold and that the authorities' perseverance in implementing policy reforms is laying a basis for resumed confidence. Nonetheless, economic and political conditions remain fragile, necessitating continued resolute efforts to adhere to and strengthen the reform effort while providing greater confidence to all investors.

The most notable development since the last review was the period of the sharp and welcome appreciation of the rupiah, which undoubtedly was associated with the authorities' efforts in implementing the Fund program, ongoing conversions of foreign assistance into rupiah in the exchange markets, and the recent appreciation of the yen. Given the sensitivity of Indonesian prices to exchange rate developments, inflation has come down sharply. Meanwhile, interest rates at SBI auctions have fallen significantly.

Since March, the heart of the Indonesian monetary program has been for authorities to adhere to a strong quantitative approach focussed on NDA, while avoiding intervention in the foreign exchange market. The authorities have stuck to the monetary program in recent months by effectively absorbing liquidity support to banks through SBI auctions, and staff has retained the existing monetary framework for the fourth quarter. Adherence to the monetary program has provided the anchor for Indonesia's recent successes. There should be no swerving from this path.

In this context, the renewed weakness of the rupiah in the past week underscores that the recent tendency toward strengthening in the currency is not secure. Hence, should the rupiah begin appreciating anew, we see little basis for anything more than a cautious, prudent and gradual approach to easing interest rates.

The rupiah's recent firming, the impracticality of widespread subsidization in view of the large scope for leakages from the economy, and the volatile situation earlier in the fiscal year are all playing a role in curbing spending and the fiscal deficit. Nonetheless, given the dire situation facing Indonesia's people and the imperative of limiting hardship, the authorities should fully use the fiscal maneuvering room afforded by the significant international effort that has been made to mobilize financing to support Indonesia.

Against this background, we welcome the government's commitment to accelerate development spending, while taking into account the need to address the reports of systemic corruption outlined in a recent World Bank report, and we urge Fund and Bank staff to work closely with the authorities to help ensure that appropriate procedures are put in place that allow these resources to be used effectively for their intended purpose. We also urge Fund and Bank staff to collaborate closely in focussing on the composition of spending. In this context, we hope staff will intensify its discussions with the authorities on directing resources away from unproductive purposes, such as excessive military spending, and toward productive purposes, such as social programs to protect the neediest and measures to promote restoration of long-term sustainable growth. We also are pleased that rice prices have declined and that further efforts are being undertaken to expand targeted provision of rice supplies to the truly needy.

As noted in our past statements, financial sector and corporate restructuring are interdependent processes and the key challenges to be addressed for the revitalization of the economy.

On financial sector reform, we commend the MAE and Bank teams for their intensive and ongoing work with the authorities, and we thank MAE for the detailed annex. Parliamentary approval of the amendments to the banking law is an extremely welcome step that will provide IBRA's AMU the requisite authority to seize, hold, and dispose of assets, as well as allow for increased foreign ownership in the banking system. A strong AMU is likely to be one of the keys for successful bank and corporate restructuring. Also, we welcome the merger of the four state-owned banks and the intention to submit to Parliament a draft law to provide for BI's independence.

The announcement of the recapitalization program is an important flanking measure in financial sector restructuring. That the costs of recapitalization are rising is hardly a surprise. Obviously, the true test of this program will be in its implementation, and this the authorities should carry out decisively. But we do have some questions regarding the program's focus on banks with CARs of better than minus 25 percent but less than 4 percent of assets. It was our impression that the strategy behind Indonesian bank restructuring was to identify a small group of sounder "champion" banks which would form the basis of a strengthened and highly truncated financial sector, while closing down the remainder of the banking system in an orderly fashion. Although full audit results are not yet known, and it is unclear whether any banks have more than 4 percent capital adequacy, it appears there may be a focus on recapitalizing second-tier banks (as opposed to "champion" banks). If so, this may not be the most appropriate deployment of resources. Also, even if the government stands ready to provide 80 percent of the funds for recapitalization for the targeted banks, it is not certain whether current owners or new investors will have adequate incentives to inject new capital given that negative spreads and heightened risks more generally may give rise to the possibility of further decapitalization.

We are pleased to hear from staff that the differences of views regarding the repayment of liquidity support, which delayed the Board's consideration of this review, are being resolved, and we look forward to quick implementation of the agreement. This financial settlement should now be extended in a uniform, equitable and transparent way to all of the concerned banks, and we strongly believe this should be done before the Board's next review. More generally, this disappointing chapter underscores the need for providing IBRA autonomy, the resources to do its job and greater transparency in IBRA operations.

The Jakarta Initiative, along with the previous work in creating INDRA, provides an important voluntary case-by-case framework for corporate debt workouts. Its recent launching is a key accomplishment and we hope that restructuring agreements will be quickly reached, which in our view will necessitate substantial write-downs by creditors. However, we remain concerned that given the enormous scope of the corporate debt problem and the complexity of workouts, the case-by-case framework may not produce results with sufficient speed. Hence, to guard against the possibility that progress will not be commensurate with Indonesia's pressing needs, we hope staff is continuing its contingency planning in this area with a view towards developing measures that would strengthen incentives under the Initiative.

Bankruptcy is a key lever in providing debtors with an incentive to come to the negotiating table. Hence, staff's work in creating the framework for bankruptcy, and an independent bankruptcy court is most welcome and commendable. We appreciated the update on the cases filed to date. As staff notes, one of the cases has already given rise to considerable controversy, and we hope staff will closely monitor future cases and keep the Board fully apprised on whether the bankruptcy process is working satisfactorily. Also, given the recent appreciation of the rupiah, is any creditor interest in the INDRA framework emerging?

We are disappointed that the original timetable to remove restrictions on debt/equity conversions was not met, and we would urge more activism on the part of the authorities and the Fund and Bank in ensuring that regulatory obstacles to corporate restructuring are quickly removed.

We welcome the authorities' renewed commitment to avoid any restrictions on capital flows and the imposition of export surrender or repatriation requirements. Moreover, we support the effort to broaden coverage regarding the collection of capital flow data. But we are concerned that public remarks regarding the possible imposition of capital controls or exchange market intervention activities will undermine confidence and have unintended consequences that are contrary to the very aims which gave rise to the statements. We thank the staff for the annex on structural reforms, and we hope that the Fund staff, in collaboration with the Bank, will keep us fully up to date on Indonesia's efforts to stamp out corruption.

Finally, it is envisaged that the next review will be the last monthly one and that the program will then shift to quarterly reviews. We believe, however, that even after November, continued and active staff monitoring would be useful and desirable. In several transition countries in past years, staff held monthly missions and put in place special procedures to monitor developments very closely, even within the framework of bi-monthly or quarterly reviews; we think that these practices might provide useful precedents for Indonesia. Staff comments would be appreciated.

Mr. Mori made the following statement:

We wish to thank the staff for the helpful report on Indonesia, and also for the very informative supplement "Banking Sector Developments" and the World Bank Brief "Rice Security During the Crisis."

The staff report informs us of the recent encouraging developments in the Indonesian economy. As a result of the authorities' good policy implementation, the exchange rate reached Rp 7,500 per U.S. dollar in October, compared with Rp 11,000 in early September. One could also include the rescheduling provided by official bilateral creditors and the implementation of the Frankfurt Agreement as important factors contributing to reducing the pressure on the rupiah. Inflation has begun to moderate and there are indications that the decline in output may be ending as some sectors--such as construction, banking and services--have recorded positive growth. Overall conditions, however, are still very depressed and the number of persons in poverty is extremely high. The financial crisis has caused real GDP to decline by 15 percent in 1998.

Improvements have also been noticed in the external accounts. Exports, especially in terms of volume, increased and non-oil/gas imports recovered somewhat. With a stronger capital account, net international reserves increased. But adjustment still relies basically on the contraction of imports.

In the fiscal area, we see the need for a more rapid increase in development spending, especially on new initiatives in health, education, and employment creation. The priority is to foster a recovery in output, especially focussing on fiscal policy to provide the necessary stimulus and strengthen programs to protect the poor from the crisis.

A stronger rupiah and better prospects for inflation have allowed interest rates to ease, though credit to the private sector continued to shrink. The authorities need to continue in their cautious monetary policy management to tighten policy and allow interest rates to rise, should the exchange rate weaken or inflation show signs of picking up. It is also essential that the commercialization of food, especially rice, should be normalized to reduce the pressure for price increases caused by market distortions.

In the structural area, progress in the implementation of the Jakarta Initiative is encouraging. Confidence in the banking system continued being restored and key elements of the bank restructuring strategy are moving ahead. With recapitalization and restructuring programs under way, economic stabilization and recovery tend to make possible a favorable dynamics path to occur in the financial position of banks and enterprises. The appreciation of the exchange rate would reduce the pressure on some troubled borrowers; declines in interest rates would eliminate negative spreads in the banking sector; and the new bankruptcy law and the new prudential regulation would enable banks to improve substantially the returns on their loan portfolios. The banks will, therefore, be in a position to resume their critical functions for providing intermediation services to the economy.

Policy actions by the government have helped to stabilize the rice situation. The concern is to assure the availability and distribution of an adequate supply of rice until the next harvest. Maintaining an appropriate supply of rice in Indonesia is critical to the extent that the poor spend 70 percent of their income on food and 25 percent of the income on rice. The government-targeted rice program has been an important instrument to avoid the real income of the poor to be reduced further, though it has not provided a sufficient offset to the income shortfall to assure an adequate diet for them. Government efforts in designing and implementing a new targeted social program in a very short period of time is commendable. Key challenges remain to enhance the program to cover poor families in all localities, especially in urban areas.

We support the proposed decision for the completion of the second review of the extended arrangement and the waivers requested by the Indonesian authorities.

Mr. Yoshimura and Mr. Ogushi submitted the following statement:

It is encouraging that, with continued policy implementation, market sentiment has improved and the exchange rate has recovered and reached a higher level than expected. In accordance with this movement, inflation performance has also improved. In addition, the Jakarta stock market index has risen by about 20 percent and a movement toward economic recovery can be seen in some sectors, such as construction and banking. This chair appreciates the authorities' efforts toward the implementation of economic reforms.

It is important for the authorities to continue to steadily implement policies that promote further recovery of the economy within the framework of the program. In this connection, in order to secure this movement toward economic recovery, the authorities should accelerate development spending, which has not yet reached a sufficient level. A mere increase in volume is not sufficient. Rather, the authorities should use development spending effectively so as to improve performance in some underperforming sectors, for example, agriculture and manufacturing.

On monetary policy, as the staff indicates, it is necessary for the authorities to remain prudent, keeping in mind conditions in foreign exchange markets and in the inflation rate. In this sense, flexibility in monetary policy will be necessary. Having said that, I think a cautious easing of interest rates would be appropriate as the exchange market has stabilized and inflation has contracted.

Possible further reductions in interest rates will have a good effect on the real economy. In this regard, I would have liked to see more analysis of the effects of a reduction in interest rates in the staff paper, for example on the growth rate or on the burden of corporate debt. The staff's comments on this would be welcome.

The authorities have made it clear that they will not use capital controls. There had been speculation in the market about the introduction of capital controls. But capital controls are not, in my opinion, necessary now since Indonesia is not at risk of huge capital flight or of severe downward pressure on exchange rates. In this regard, it is welcome that the authorities' assertion that they will not resort to capital controls has removed the uncertainties in the market. In addition, the authorities intend to strengthen the monitoring of foreign exchange transactions through banks. I think this strengthening will be important since the current monetary crisis was caused by the accumulation of short-term external debt.

On structural reform, it is disappointing that the performance criteria on privatization and banking system reform were not observed. I think it is important that the authorities implement the Fund program without delay since international confidence in the Indonesian economy is just being established. I hope that these slippages will be made up as soon as feasible.

Although interest rates are decreasing now, bank credit to the private sector appears to be insufficient. I suspect that this insufficiency in credit creation is mainly due not to the level of interest rates but to the fact that corporate debt restructuring has not progressed and that the resolution of non-performing loans has been delayed. On the corporate debt restructuring, I welcome the progress in the formulation of the legal and regulatory framework of the Jakarta Initiative. Although the Jakarta Initiative has been gradually revealed, I wonder whether it is sufficiently clear to the debtors and creditors at this time. I think it will be difficult for the Initiative to come into effect quickly if its contents are unclear. I would like to ask staff to what extent the role of the task force and the scope of its power have been defined and are understood by the people concerned.

On financial sector reform, I welcome that the amendment to the banking law has been approved. I think that the rapid establishment of a fully-functioning banking system is a very important core for the economy. Since there will be a time lag between the establishment of this core and the emergence of favorable consequences in the private sector, I hope that it `will be established immediately through active implementation of the envisaged measures.

With these remarks, I support the proposed decision and wish the authorities success with the economic reform.

Ms. Brownlee, speaking on behalf of Mr. Pickford, made the following statement:

The recent marked strengthening of the Rupiah, rise in the stock market, and fall in inflation mark a welcome brightening in Indonesia's prospects over the medium term. The EFF remains broadly on track, export volumes are beginning to recover, the authorities have shown a firm and commendable commitment to maintaining an open exchange system, and the nightmare specter of hyperinflation is receding. These developments are the most encouraging news for Indonesia that we have had for very many months.

However, we must not become too sanguine too soon. The economy remains extremely fragile, and could easily be blown off course. Two major domestic risks are clear: civil instability, which could sparked by a range of factors (rice distribution, concerns over corruption, policing, ethnic tensions); and progress on the electoral front. Both factors have left long term market sentiment weak, and the sustainability of the exchange rate appreciation in some doubt. In addition, key areas of the reform agenda are stumbling; areas which could have a major impact on the sustainability of the recovery itself. This is where we would like to focus my remarks:

Securing rapid progress in the key area of corporate debt restructuring must be a priority. The strong turnout at the launch of the Initiative in Jakarta is a positive sign. However, important challenges remain. Confidence in the

Initiative is low, with a reportedly large gulf between creditors and debtors even after the meeting. Specifically, we are concerned as to whether sufficient incentives are yet in place to bring defaulting corporate borrowers to the negotiating table. It is also clear that further adjustments to tax and administrative arrangements are needed to encourage debt equity swaps. Problems also exist with the concept of establishing fair asset values whilst the economic outlook remains volatile. Lastly, bankruptcy law remains problematic and confidence in the commercial courts is proving difficult to establish. Bankruptcy is not familiar concept in Indonesia and there are doubts about the independence and quality of the judiciary.

The approval by the House of Representatives of the new banking bill on October 16 is a fundamental step forward in the restructuring process. However, the problems experienced over the first few settlements negotiated by IBRA have highlighted the need to ensure that the process of settlement, which can involve individual deals in excess of 2 percent of GDP, is done in a transparent manner. We would be grateful for a comment from staff on what improvements they propose in this area, including the establishment of the Independent Review Committee.

The overall cost of bank restructuring will be significant, although the final cost will be sensitive in particular to realization of asset procedures which are yet to be fully worked out. The phasing of the cost of restructuring appears to lead to a manageable burden in the coming few years, but we are concerned about the capacity of the bond market. We would support further technical assistance, and we would also hope that decisions are taken soon on who will lead on policy in this area. The supervisory capacity of the central bank is also an outstanding issue.

As staff recognize, aside from reducing the direct impact on poverty and unemployment, low expenditure on development and social safety net measures has important implications for the level of the fiscal stimulus. The delays in disbursements and project approvals are symptomatic of significant underlying problems, including difficulties within the distribution networks, and major incentives for corruption throughout the safety net programme. We support Bank and staff's efforts to make progress in this area, and look forward to a further report at the time of the next review.

Both the political and economic conditions remain difficult and fluid. It is clear that the Indonesian authorities have responded well to the supportive environment that monthly monitoring provides. On current plans staff propose to move to quarterly monitoring after the November review. We would suggest that given the vulnerability of the economy, maintaining a more intensive relationship would be more appropriate for the time being. We would be grateful for comments from Mr Zamani and from staff on what other options could be considered.

Finally, I would like to commend both staff and the authorities for their continued commitment and perseverance in often difficult circumstances. I would also like to thank staff both in the Fund and the Bank for the very helpful background papers for today's meeting.

Mr. Al-Tuwaijri made the following statement:

I commend the Indonesian authorities for their continued adherence to the economic program under very difficult circumstances. These efforts coupled with increased external financing have helped improve confidence. As noted in the staff paper and by staff today, the rupiah appreciated markedly, the stock market strengthened, and inflation moderated.

Unfortunately, economic activity continued its contraction albeit at a slower pace, and poverty levels remain extremely high. Therefore, the main focus at this stage should be on accelerating the recovery. This will require vigilance in program implementation as well as continued international support.

On fiscal policy, it is crucial for the expenditures to increase in line with the program. In this regard, the rise in spending on social programs last month is welcome and should be accelerated in the coming months. Indeed, rising social tensions underscore the importance of strengthening the social safety net and increasing spending on poverty alleviation. Here, I fully endorse the intention to substantially expand the targeted subsidized rice program to cover a larger share of the poor.

Turning to monetary and credit policies, I welcome the recent reduction in interest rates which should help the ailing banking and corporate sectors. The sharp appreciation of the rupiah and the improved outlook for inflation should facilitate a continuation of this trend. Of course, the authorities will need to monitor the situation closely in order not to undermine the progress made on the exchange rate front. In addition to lowering interest rates, it is essential to ensure that viable firms have adequate access to credit.

On the ongoing restructuring of the financial system, I endorse the authorities' efforts to quickly establish a fully functioning core banking system. In this connection, recently announced recapitalization of viable private banks and the initiation of the merger of four state banks should help achieve this objective let me add that I welcome today's agreement with three banks as mentioned by Mr. Neiss earlier. The progress made in improving disclosure and enhancing the prudential and regulatory frameworks should also facilitate implementation of this strategy.

Speeding up efforts to restructure the corporate sector will reduce the cost of bank restructuring and help stage a recovery. In this regard, the progress made in implementing the Jakarta initiative and the strong interest by both debtors and creditors in the initiative bode well for the future. The ongoing work of the commercial court to address bankruptcy petitions should also advance corporate restructuring. Here, I agree on the need for further efforts to strengthen the capacity of the court along the lines detailed in the staff paper.

With those remarks, I support the proposed decisions and wish the authorities success.

Mr. Kiekens made the following statement:

It is encouraging to see that the implementation of tight monetary policy has finally produced positive results by reducing inflation and strengthening the rupiah. Progress with stabilization is especially important because it makes more room for policies aimed at supporting growth. This year's sharp output decline has made the authorities understandably impatient take actions that will stimulate growth, but this must be done in ways and on a scale that will not undermine the still fragile financial stability.

One area where the authorities could do more to support domestic demand and growth is fiscal policy. Up to now, current expenditures and development spending have been below the program target. According to the authorities, this is not only to administrative delays but also to concern about inadequate budgetary control of development spending, which creates a risk of corruption. This concern is understandable, but the seriousness of the present economic situation requires the authorities to keep everything in perspective. Dealing as they are with an economic contraction of 15 percent, they must act swiftly even if some of their budgetary controls are not yet perfect. The costs of delaying new spending initiatives could easily be higher than costs due to leakage and less-than-perfect budget procedures. Decisions in this area must be based on common sense, balancing the economic costs of spending delays against the political costs of expediting spending even at the risk that this will result in some corruption. The authorities should begin implementing these spending initiatives, promptly correcting the shortcomings of budgeting and administration as they arise. I have noted press reports that an internal memorandum of the World Bank states that in Indonesia, corruption is pervasive, institutionalized, and a significant obstacle to the effectiveness of the Bank's assistance. I wonder whether the staff can shed any light on this, and whether we should anticipate any considerable delays in World Bank lending to Indonesia.

On interest and exchange rate policies, I have the following comments. The authorities are worried about the effects of high interest rates on the corporate and banking sectors. Obviously, highly indebted corporations are sensitive to high interest rates. But this concern should not be allowed to compromise the main objectives of monetary policy, which are to bring down inflation and stabilize the exchange rate at an acceptable level. The negative effects of the high debt burden are to be addressed mainly by debt restructuring. I therefore hope that the Frankfurt agreement on a framework for corporate debt restructuring will start producing results as INDRA becomes operational. Of course, any lowering of interest rates is welcome, but only in the absence of any weakening of the currency. As Ms. Lissakers has pointed out, the renewed weakness of the rupiah underscores the fragility of its recent strengthening, and caution is therefore in order. We should not forget that the recent strengthening of the rupiah may also be partly due to the fact that most Indonesian corporations are not presently servicing their external debt. Once more companies begin to service more of their debt, the demand for foreign currencies will increase and the rupiah could weaken again.

On balance, I think monetary policy can now become more supportive of growth. With inflation falling rapidly, as indicated by preliminary data for October, leaving nominal interest rates unchanged would sharply increase real interest rates. I therefore see room for more interest rate cuts.

Indonesia's chances for economic recovery depend largely on the progress made with structural policies, and most of all on progress in dealing with the banking crisis and corporate debt. I welcome the progress with bank restructuring, as reported by Mr. Neiss at the outset of the meeting. I was nonetheless somewhat concerned that some of the structural benchmarks have not been met. At this stage this appears to be more a consequence of the complexity of the authorities' task than of backsliding on economic reforms. Even so, I was somewhat disappointed by the slow pace of privatization. The authorities have postponed the privatization of twelve state enterprises that were marked for sale in June, and reduced the share of ownership to be sold in the cement producer from the originally-planned 51 percent to 14 percent. I am not sure that the authorities can afford to continue holding up privatization while waiting for market conditions to improve. The weakness of market conditions cannot have been a very great surprise, and the authorities' hesitation to proceed with the sales as originally planned could be understood as indicating a weak commitment to privatization.

Finally, I would like to restate my appreciation for the authorities's commitment to their open exchange system. The imposition of exchange rate restrictions and capital controls would not only be difficult; more importantly, it would scare away foreign capital, something Indonesia can hardly afford. Let me also say that I much welcome the intention of Bank Indonesia to monitor closely foreign exchange flows on a daily basis. I think that this is the right way for other countries to respond to possible risks of short-term capital movements.

I support the proposed decision and wish the authorities success.

Mr. Daïri made the following statement:

As pointed out by Mr. Zamani in his helpful statement, there are encouraging signs that the Indonesian economy is stabilizing. This is certainly welcome news. The exchange rate has strengthened, inflation has started to moderate, interest rates have eased, and the external position has improved, led by a notable pickup in export volumes and a capital account that has been surprisingly strong. More importantly, there are signs that the precipitous decline in output has slowed and a bottoming out in activity is at hand. These positive developments reflect the authorities' commitment to implement the policy framework under the extended arrangement and their determination to keep the program on track, as well as the market's growing confidence in the overall conduct of economic policies.

Despite these favorable developments, as the staff report and Mr. Zamani indicate, the economic situation in Indonesia is still precarious. Risks abound from the uncertainty stemming from the continued volatility in the region and depressed commodity prices. This renders the authorities' task more arduous. Fiscal policy has provided insufficient support to activity and needs to be placed on a more expansionary course. We are mindful of the administrative difficulties associated with the redirection of spending and the importance of appropriate budgetary controls, but an acceleration in development spending and implementation of measures aimed at protecting the poor should be given highest priority, along with actions to reverse the shortfalls in external financing for the budget. One wonders what purpose is served by maintaining a performance criterion on the overall government balance when the real problem is underperformance in spending. Maybe it would be more appropriate to replace the quantitative performance criterion on the budget deficit with a structural benchmark on the budget control system.

Much of the improvement in the macroeconomic environment is due to the tight rein that has been maintained on monetary policy. Given the accomplishments to date, especially on the exchange rate and the inflation front, we support a cautious easing of monetary conditions through a further gradual decline in SBI interest rates in order to revitalize the economy. This should also help reverse the negative spread that has emerged between commercial bank deposits and lending rates.

We agree with the staff that an easing of monetary policy should be implemented with pragmatism and flexibility. Could the staff comment on the possible effect of the postponement of the Board meeting on Indonesia on the sharp depreciation of the rupiah since last week? I am raising this issue in order to underline the risks attached to the high frequency of Board reviews, but also to indicate that the reversal of the recent appreciation is only temporary. I also wonder at what level the exchange rate appreciation would start to affect competitiveness.

Steady progress on structural reforms must remain high on the authorities' agenda. The progress in bank restructuring has been encouraging, with the passage of the amendments to the banking law and the scheme for the recapitalization of viable private banks. It is important for the authorities to persevere on the agreed steps. Progress with corporate restructuring is also crucial for economic recovery, and we join Mr. Shaalan in welcoming the removal of regulatory impediments on debt to equity convergence and tax disincentives for corporate restructuring. We commend the authorities for the steps taken to strengthen the monitoring of short-term capital flows, and look forward to the submission to parliament of the new law institutionalizing Bank Indonesia's autonomy.

Finally, the Indonesian authorities deserve to be commended for their commitment to the reforms and policy measures set out in the arrangement and for their accomplishments to date. We support the proposed decision and hope that the authorities' continued efforts at adjustment and reform will be generously supported by the international community.

Mr. Guzmán-Calafell made the following statement:

The positive impact on confidence of the economic strategy under implementation in Indonesia has been evident over the last month. The exchange rate is the variable where the strengthening of confidence is observed with more clarity, as the rupiah has appreciated far beyond the assumptions incorporated in the economic program. Market confidence has also reflected in the behavior of the stock market index and interest rates. The good news also encompass a number of other economic indicators. Thus, inflation has fallen sharply, there are signs that the decline in output is close to an end, the accumulation of international reserves has surpassed program levels, and progress continues in the structural transformation of the economy. The Indonesian authorities are to be commended for all these achievements.

Notwithstanding the progress made, the situation of the Indonesian economy remains extremely difficult. From a macroeconomic standpoint, the main concern at this stage is to foster the recovery of economic activity. While the rate of decline in output has eased and may soon bottom out, this is by no means certain and the projections of a decline in real GDP of 15 percent this year are worrisome.

It is therefore unfortunate that fiscal policy has failed to provide the expected stimulus to economic activity. The authorities are taking steps to accelerate development spending, and according to the staff expenditure on social programs already began to accelerate in September. These efforts are welcome, but at this stage it seems unlikely that fiscal policy will play this year the role it was expected in stimulating demand growth. In particular, I note in Table 5 that the economic program assumed an overall deficit for the central government of 6.8 percent of GDP in April-September; instead, a situation close to balance is currently estimated for this period. With this information at hand, it is difficult to anticipate an acceleration of spending during the last quarter of the year that allows to meet the targeted fiscal expansion for 1998/99. This is clearly an area where additional efforts are needed.

There may also be a role for monetary policy in fostering economic growth. So far, the authorities have been able to combine a strengthening of the exchange rate with a decline in interest rates. However, the appreciation of the rupiah beyond program expectations, the decline in the inflation rate, and the larger than programmed accumulation of international reserves, suggest that there is room for further interest rate decreases. Naturally, this is an area where great caution is needed not to undermine confidence, as the recent volatility in the rupiah shows, and therefore the authorities must continue to adhere to the prudent approach described in Mr. Zamani's helpful statement statement. On the other hand, the existence of a negative spread between commercial bank deposit and lending rates is a source of concern, since it adds to the already very serious difficulties affecting the banking system. I would like to hear some additional staff comments on the reasons for this, as well as on the extent to which further declines on SBI rates may contribute to solve this problem.

On bank restructuring, I am glad to learn that the key elements of the strategy are moving ahead, and that the pending issue of repaying the liquidity support provided by Bank Indonesia to several commercial banks has finally been solved. I share the staff's views on the importance of adhering to the agreed timetable on the recapitalization of banks and state bank mergers. On the other hand, I am concerned by the recent upward revision of the cost of bank restructuring. As explained in the report, the latter is currently estimated at about 30 percent of GDP, and provisions to meet interest payments on the bonds issued to cover these costs are projected at some 3 percent of GDP in fiscal year 1999/2000. I am aware of the limitations faced by fiscal policy at this stage, but since these figures are very large, I believe it is important to hear an explanation by the staff on the challenges that the costs of bank restructuring pose for public finances in coming years.

Efforts in corporate restructuring are in general terms satisfactory. This is a crucial area for the resumption of growth and the challenge now is to ensure that the measures under consideration adhere to the announced schedule. On previous occasions, the staff has pointed to the extremely weak position of many companies and to the possible need for debt write downs for the rehabilitation of a large number of them. I assume that the problems of the corporate sector have been alleviated to some extent by the appreciation of the rupiah, but I would be interested in an up date by the staff on the present situation of the corporate sector in Indonesia.

Finally, I wish to express this chair's support to the proposed decision, and to wish the Indonesian authorities all the best in the period ahead.

Mr. Esdar made the following statement:

We welcome the recent progress achieved in reducing inflation and in stabilizing the exchange rate. In order to support these welcome developments and to improve the conditions for economic recovery it is crucial to press ahead with the necessary bank and corporate restructuring. Against this background, it is regrettable that, in some areas, implementation of the program has been delayed, notably in the area of privatization and with regard to institutionalizing Bank Indonesia's autonomy.

Furthermore, it is important that the authorities' structural reform efforts are accompanied by a continued cautious monetary policy, an appropriate and efficient implementation of social and employment programs, as well as by a further reduction of inefficiencies in rice distribution, especially to the neediest.

On monetary policy, the recent progress with stabilization have, indeed, provided some room for a cautious monetary easing. We fully endorse, however, staff's view that "monetary policy will need to be conducted flexibly, and the authorities should be ready to tighten policy if the exchange rate weakens or there are signs that inflation is not declining as envisaged".

One brief remark on fiscal policy: As already indicated during our last discussion, I continue to be concerned about the under-performance in particular on social spending, and I fully subscribe to Mr. Bernes' call "on the Government of Indonesia to rapidly raise budget spending to the targeted level".

On corporate restructuring, slow progress in this area still hampers the process of economic recovery. High priority should therefore be given in particular to debt restructuring, and the Jakarta Initiative should become fully operational as soon as possible.

To be more concrete, it is quite disappointing that tax disincentives for restructuring and obstacles to debt for equity exchanges, originally envisaged to be removed by end-September, are still in place. I would very much appreciate staff's comments on the status of these efforts and on the status of the activities of the Jakarta Initiative Task Force.

On privatization, I would appreciate staff's comments whether the delays in privatization are caused by unfavorable market conditions or - as noted in press reports - also reflect the authorities' general hesitation with regard to foreign participation.

Finally, a couple of remarks on bank restructuring. In this area it is crucial to limit the costs of bank restructuring to the government and to avoid inefficiencies. This requires, inter alia, the full disclosure of bad loans and the strict limitation of government-assisted recapitalization programs to only viable banks. In this context, however, I wonder whether the qualification requirement of a minimum capital adequacy ratio of "minus 25 percent" would be a too generous benchmark.

Furthermore, ways have to be found for non-performing assets that have been transferred to the "Asset Management Unit" to be evaluated in line with market requirements, and their subsequent disposal. In addition, it is also important that restrictions on foreign ownership of domestic banks are effectively eliminated—I assume that, at least in formal terms, this has been done with the passing of the amendment to the banking law on October 16. I would appreciate if staff could confirm this.

Finally, in order to minimize the final costs of bank restructuring to the government satisfactory arrangements for the repayment of liquidity support to private banks have still to be agreed, as staff rightly pointed out.

With these remarks, Mr. Chairman, I support the proposed decision.

Mr. Blancher made the following statement:

Let me first commend the Indonesian authorities for their continued good policy implementation, which has led to progress on the stabilization front and to encouraging new signs of turnaround, both domestically and externally. I will just raise four brief points:

On the fiscal situation. Like others, I would like to reemphasize the importance of actually using the headroom made available for increased social and development spending. This has been the purpose behind the international community's strong efforts in favor of Indonesia during the present difficulties. I very much hope that the progress made in September signals that delays will be made for in the coming weeks.

On the external side, shortfalls on foreign bilateral and multilateral financing for the budget are a matter of concern. Some of these may be linked to fiscal delay and slower than anticipated project implementation in Indonesia. But could staff provide more details on the other causes for such substantial shortfalls?

Looking ahead, and taking into account delays in bank restructuring and in the establishment of safety nets, as well as lower subsidies due to the recent appreciation of the rupiah, I would be interested in staff views on the probability that the expected external financing gap for fiscal year 1998/99 could be significantly revised?

On banking and corporate restructuring, I want to thank staff for a very informative and useful annex paper, and Mr Neiss for the additional information provided at the beginning of this meeting. I welcome the recent progress achieved, particularly regarding amendments to the banking law. On corporate debt, further progress is urgently needed to demonstrate that the new bankruptcy framework will be rigorously implemented. This will constitute a major incentive to increased participation.

Finally, I support Mrs Lissakers' proposal to explore further means to maintain a close monitoring of the program after the end of the year.

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

Mr. Kapteijn made the following statement:

I can support the proposed decisions. I would like to start by thanking staff for the very informative supplement on banking sector reform as well as their annex on structural reform, which was requested at the last meeting. I found it very helpful in showing where we are, how far we have to go, but also how much has already been done.

Clearly there is a lot of confidential information in the supplement on banking reform which is not suitable for publication. Nevertheless, I wonder whether it would be useful to make at least some of the information public, with the consent of the authorities of course. In this regard, I found the overview of the sequence of events particularly useful as it clarifies that much of the panic and bank runs which occurred were due to events unrelated to the IMF's actions or the bank restructuring efforts themselves. This is important as the IMF has been widely criticized for setting off bank runs by the early closure of the 16 private banks late last year. This report usefully shows that other factors, both external and political, were at play and that other actors were involved. I recall that we included a section on Russia in the WEO to also clarify the sequence of events leading up to the default in August, which also shed light on what the Fund was and was not responsible for. We could consider doing something similar for Indonesia.

Let me then turn to the main aspects of the program. First, monetary policy. At the last meeting, this chair noted that it would be premature to ease interest rates as the exchange rate was still well above 10000 Rp per dollar, volatility of the exchange rate was still high and confidence fragile. Thus we advocated erring on the side of caution. This vigilance now seems to be paying off. Within the course of only a few weeks the nominal exchange rate has appreciated by over 3000 Rp, although some slippage has occurred in recent days. The more appreciated exchange rate substantially improves the outlook for the INDRA restructuring, reduces the cost of remaining import subsidies and hopefully provides a welcome stimulus to imports. I agree with staff that there is now some scope for further interest rate reductions. Nevertheless, I continue to stress, like others, that these reductions should be both cautious and gradual. In addition, if the exchange rate deteriorates or the inflation outlook weakens, the authorities should stand ready to tighten policies again.

My second point concerns the announcement by Indonesia that it will enhance the monitoring of foreign exchange flows. I believe this should be welcomed in light of the significant flaws in banking data which emerged at the time of the Frankfurt agreement several months ago. However, press reports continue to be concerned that this is a masked attempt to introduce some kind of capital controls. In this regard, I welcome repeated statements by the authorities to the contrary. It may also be useful to give some publicity to the fact that the IMF is providing technical assistance in this area, so as to further soothe the market concerns. In addition, it could be useful to make matters more innocuous and point to other countries which are improving their statistical systems in similar fashion. Would it, for instance, be a fair description for Indonesia to say that they are attempting to bring their reporting systems up to the standards of more advanced economies?

Thirdly, I am somewhat concerned about the delay in privatization. I concur that the reasons for these delays are certainly understandable. Nevertheless, delays in privatization could signal a stalling of structural reform. I wonder if there is some way to pre-emptively manage market expectations in this regard. It would perhaps be useful if staff could indicate what market expectations actually are.

Finally, I have a question on the recently approved banking law. My understanding is that this law may be in many ways flawed, or at least not commensurate with the recommendations MAE and other staff had made during their mission in the summer and which they had laid down in a report to the Indonesian authorities. This is potentially a serious cause for concern as it may cast doubt on the ability of IBRA to function. In this regard, I would like staff to comment on the following questions:

1) Is it true that when at the time of writing of this staff report, staff did not yet have knowledge of the precise content of the banking law legislation?

2) Is staff now satisfied with the banking law? If not, how serious are the caveats, how seriously do they affect IBRA, and how long will it take to correct them.

Mr. Faini made the following statement:

The Indonesian economy has made substantial strides toward stabilization. The task ahead is to consolidate these gains and lay the foundation for the resumption of sustained and noninflationary growth.

On the stabilization of the exchange rate, the Indonesian rupiah has appreciated by approximately 30 percent with respect to the U.S. dollar. To some extent, this reflects both the fall in international interest rates and the weakening of the U.S. dollar, in particular, with respect to the yen. Yet, we should consider that the extent of the appreciation of the rupiah is more substantial than that of the currencies of the other four Asian crisis countries. For instance, the Thai baht—the second best performing currency among those countries—rose by only 7 percent during the same period. Still, we should not lose sight of the fact that the rupiah has depreciated by 67 percent since June 1997—more than any other currency in the area. It is still possible, therefore, that the appreciation in June 1997 may simply reflect an overdue correction with respect to the previous overshooting of the exchange rate.

Although there has been improvement in the external balance, by more than what the staff had forecast, the authorities should not be complacent. Much of this improvement simply reflects a dramatic compression of imports comparable to what happened in Latin America in the aftermath of the debt crisis. Exports have increased in volume terms, but all of these gains have been dissipated, as seen by the fall in the unit price of exports. Indonesia is not a small country facing fixed world prices for its exports. I would like to ask the staff to explain why export prices fell so much. My feeling is that falling export prices may reflect the parallel export push of many Asian countries in the wake of the financial crisis that hit the region, and the depressed demand conditions, particularly in Japan. We should recall that, contrary to widespread beliefs, Asian countries trade a lot among themselves, and, as a result, are quite vulnerable to regional economic downturns. In this light, the recent weakening of the dollar and the appreciation of the yen may be a mixed blessing in that it may further jeopardize the prospects for the recovery of the Japanese economy.

We fully agree with the staff recommendation for the completion of the second review, despite the fact that a number of performance criteria were not met, especially the share of sales in state enterprises and the central bank law. We are aware that systemic reform is a long-lasting process, and attempts to unduly accelerate it may even backfire. However, we believe that unjustified delays can undermine the confidence that the reform process will be sustained. This is a difficult trade-off and it is particularly clear in the field of privatization. On the one hand, privatization is designed to improve efficiency of resource allocation and to send a clear signal to the market that the government is committed to reform. On the other hand, not all enterprises can be privatized abruptly because market conditions may not be favorable, or more crucially, because the regulatory framework is not yet in place. This is particularly true for the telecommunication company, which is one of the firms which was delayed. We know that these firms, while in public hands, typically hold a monopolistic position, and we do not want to replace a public monopoly with a private, unregulated monopoly. Also, a clear and effective regulatory framework is needed. I am not advocating that privatization should be postponed or delayed. Quite the contrary, I am only pointing out what needs to be done for privatization to be more effective. We are also concerned by the staff's statement that shortfalls in privatization receipts are likely to limit the extent of budgetary overperformance in 1998 and in 1999. Privatization receipts should not be treated as current receipts. They should be used to reduce the stock of public debt and to pay for part of the cost of bank restructuring.

We agree with the previous speakers that substantial progress has been made on several other fronts, such as bank and corporate restructuring, which are essential elements to lay down the foundation of economic recovery. However, we remain somewhat concerned in many respects.

Many of the gains, namely, the easing of the pressure on currency, the fall in inflation, and the decline in domestic interest rates, can—to some extent—be attributed to exogenous factors, such as the fall in international interest rates. In this context, we believe that the premature or rapid easing of monetary conditions may have detrimental effects on confidence and financial stability. The recent depreciation of the rupiah—more than 13 percent since October 22—provides a reminder in this respect. We have to understand what the causes of this recent evolution are.

Bank restructuring will improve the balance sheets of banks, but may do little to cut down the losses in the banking sector. As indicated in the staff report and by other speakers, lending interest rates are often lower than deposit rates simply because firms can not sustain the pressure from higher interest rates. However, if markets perceive that the financial situation of banks may further deteriorate, this will shake the confidence in the banking system, keeping interest rates unsustainably high and putting a further burden on the budget.

Confidence is indeed the key issue. Unfortunately, confidence is a fairly elusive concept. We are concerned, however, that foreign direct investment, at least from what we can see from the staff report, has fallen substantially, compared to what has happened in other countries in the region. Similarly, in Mexico and Argentina, foreign direct investment proved to be quite resilient, even during the recent balance of payments crisis. The steep decline in foreign direct investment can not be taken lightly. It may signal that markets are not fully convinced on the solidity of Indonesia's economic recovery.

> Social support for the reform program is essential for its success. While I can only join most of the previous speakers in expressing my concern for the seeming inability to raise fiscal spending for social and development purposes, before joining the Board, I would have never thought that there would be basic unanimity in calling for an increase in fiscal spending. When we look at social and development spending, we should recall that poverty in Indonesia, after falling to 15 percent in 1996 from 60 percent 36 years before, has now increased dramatically. Although we do not have firm estimates, present estimates in World Bank reports and other publications range from 25 to 40 percent. We fully support the program in its attempt to increase the number of people that can be reached by poverty alleviation programs. We also praise the attempt to reduce those subsidies that provide little benefit for the poor and, at the same time, favor the expansion of other programs, such as the subsidized sale of low quality, imported rice that are quite well targeted to the poor.
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> We agree that Indonesia has made substantial progress: the pressure on the currency is easing; the external payments situation is improving; inflation is receding; and the recession may be bottoming out. Yet, the policy dilemma is to determine to what extent can the evolution be attributed to sound policies or to favorable exogenous shocks. Let me finally congratulate the Indonesian authorities for their substantial progress on both the stabilization and the structural adjustment front.

The Director of the Asia and Pacific Department, in response to questions on the economic outlook, stated that GDP in the fiscal year 1999-2000 would remain flat and inflation would be below 10 percent. After the next review in a month's time, a reassessment of the macroeconomic framework as well as of the balance of payments gap would be done. There have not been any revisions to the assessment since the June review.

On the feasibility of holding monthly missions within the framework of bimonthly or quarterly reviews, the next review in November under the present plans would be the last monthly review, and then the reviews would be on a quarterly basis, the Director continued. However, the staff had suggested to management to have a transitional period until the middle of 1999 where there would be bimonthly reviews, and management has agreed to that suggestion. That proposal would be made to the authorities during the next review. Under the bimonthly reviews, there would still be the possibility of having monthly staff visits if that was considered necessary. Also, the new proposal would reduce the burden on the authorities—although they were in favor of monthly reviews—as well as the burden on the staff and the Board.

Concerning fiscal policy, there had been substantive shortfalls in foreign financing for the budget during the earlier months, the Director remarked. However, in September, the gap between planned inflows under the program and actual inflows had fully closed. In light of that catching up, higher inflows than the gap were expected in November.

On whether the staff was continuing to target the exchange rate at 10,000 rupiah per U.S. dollar or the current rate of 8,400 rupiah per U.S. dollar, the Director stressed that it had been decided at the beginning of the program that there would be no exchange rate target. However, for program purposes, in particular for calculating the budget, an assumption had to be made. The exchange rate assumption for June had been 10,600 rupiah per U.S. dollar. That level had been chosen as the average of the current fiscal year, and the level of 10,000 had been chosen for the last two quarters of the fiscal year. In earlier letters of intent, it had been made clear that those exchange rate levels had not reflected a limit on where the exchange rate could go. Further, the government had expressed in the last letter of intent that they expected the exchange rate level to move beyond that level, and it had.

It was difficult to determine precisely the reasons for the recent strengthening of the rupiah, considering that there were internal as well as external reasons, the Director remarked. However, there were several factors that had contributed to that strengthening. First, rice prices had stabilized after the sharp increase in June, just prior to the riots. Second, official foreign financing had increased as a result of the program being augmented. That gave the markets assurances that there would be enough foreign exchange. Third, confidence in the implementation of the program had increased. The program has remained on track and every monthly review so far has been approved by the Board. Moreover, there were substantial disbursements made each month, which the government had properly announced to the public. Fourth, the political situation, despite the recent tension, has become clearer. All those factors were responsible for the upward trend in the rupiah. That trend has accelerated owing to the appreciation of the yen, and, more generally, by an improvement in the regional climate.

In response to whether the recent gains in Asian financial markets, including in Indonesia, were justified by economic or structural improvements, the Director pointed out that the external situation has stabilized: reserves have increased, the current account surplus has increased, the exchange rates has appreciated, interest rates have come down in countries outside Indonesia, and the output decline, while continuing, has been moderating in all countries.

The immediate effect of interest rate declines has been on the banking sector because that allowed banks to reduce the high negative spreads between funding costs and lending, the Director remarked. Once the lower funding costs were transmitted to lending rates, that would help enterprises finance their working capital, as well as revive investment demand. However, there was one condition: banks must be willing to lend. That could only take place if the pace of bank restructuring has sufficiently progressed. That was why the programs had emphasized accelerating bank recapitalization, disposing of bad assets, and other steps to bring the banks back to normal functioning.

So far, three banks have made arrangements to repay their liquidity support, the Director noted. There were altogether 13 banks under IBRA which would have to go through that process. Once the initial problems have been overcome, the remaining banks would follow more quickly. In fact, he had just been informed that one or two large banks might sign tomorrow. Although the framework was established, it would have to be adapted to the individual banks, because not all banks were in the same position.

Thus far, interest in the INDRA framework was still dormant, the Director commented. However, as the exchange rate stabilized at a favorable rate, that interest would emerge. Before creditors and debtors agreed to put their deal into INDRA, they have to agree on debt restructuring, because in many cases some initial debt reduction would be necessary.

The staff shared the assessment that the main problem in Indonesia was the recession, the Director said. Thus, the policy discussions would focus on how to get the economy out of the recession. There were two directions. One was to stimulate domestic demand through a more aggressive fiscal policy and through a gradual relaxation of monetary policy. The other was to accelerate bank restructuring and corporate debt restructuring to create the conditions for new lending. Given that the downturn was also the result of structural problems, it had to be attacked from both sides.

Although the problem of the under performance of government spending still existed, the government seemed to be catching up, the Director remarked. Also, as official inflows increased, the spending situation would improve. However, it was not clear whether the entire fiscal expansion that was foreseen in the program would be reached; some of that might spill over into the next fiscal year.

The postponement of the Board meeting, particularly the press reports that the program had gone off track, had partly caused the recent depreciation in the rupiah, the Director noted. The rupiah had not recovered quickly, which indicated that the political tension prior to the special session of the national assembly was a strong factor. The rupiah has appreciated slightly again, but there would be some volatility until the special session was over.

In response to comments by a few Directors that there was scope for further interest rate decreases, the Director pointed out that Bank Indonesia had been cautious and gradual in lowering interest rates and also in lengthening the maturities of its outstanding paper. Bank Indonesia looked at inflation and at the exchange rate, and then acted cautiously. Bank Indonesia also intended to stay within its tight base money targets. Certainly, once the inflation was firmly down and the exchange rate depreciated beyond 7,000 rupiah per U.S. dollar, a more aggressive policy might be appropriate.

There was a clear lag in privatization compared to earlier forecasts, the Director noted. Clearly, market conditions could not be ignored, but other factors, including bureaucratic factors and political factors, were also to blame. The present review mission, including the World Bank mission, would tackle that issue again.

The improvements in Indonesia have taken place despite a number of unfavorable external shocks, the Director pointed out. One was the drought, which had been one of the most severe in the century, negatively influencing the whole rice economy. Another shock was the sharp drop in oil prices, which had significantly influenced Indonesia's balance of payments and the budget. There also had been the various shocks from the transition to a new government, coupled with political uncertainty and massive capital flight.

Mr. Sivaraman asked what would be the impact of a further depreciation on the future export prospects of the crisis countries. Indonesia has substantial manufactured goods exports, with a high import content. What would happen to that sector when they started importing at the highly depreciated rate?

Ms. Brownlee stressed that the process of bank settlements should be transparent, and asked the staff to comment on that.

The Director of the Asia and Pacific Department responded that the government intended to make public the terms of the settlements. However, it was not clear whether that would be done before or after the special session of parliament.

The staff representative from the Asia and Pacific Department, in response to questions and comments, made the following remarks:

> The shortfall in foreign financing in the first semester of the fiscal year, which would be through the end-September 1999, was about $2 billion. Around $400 million was the result of delays in the release of the second tranche of the World Bank SAL, and bilateral loans were also behind program levels by around $900 million. Project financing, which would also be directly linked to fiscal outlays, was behind by around $400 million. In addition, there was another $300 million shortfall, which included, among other items, the rescheduling of debt, which took place slightly later than assumed in the program.
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> Regarding the monitoring of capital flows, the Fund's Statistics Department has a mission in the field at present to assist the authorities in developing a system that would provide them with timely data on foreign exchange flows through the banking system. Both the authorities and the Fund felt that any such system should not impose an undue reporting burden on the banks. The aim would be to form an electronic system that classifies aggregate data and is able to provide it to Bank Indonesia rather quickly. That would provide a better feel of how things are evolving from week to week.
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> In response to Mr. Sivaraman's question, we are looking closely—albeit in a judgmental sense—at the development of exports. Clearly, such an exercise involves great uncertainty, given that one has to take into account the actions of the various competitor countries. Unfortunately, there is little informational content in an econometric-based analysis, at this juncture, given the major structural shocks, that the economy has experienced in the past year. The previous staff report included a box on export performance, and the staff will continue to report on that issue.
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> With regard to interest rates, the negative spread problem stems from the fact that banks have formed a judgment that their clients are unable or unwilling to pay market interest rates; therefore lending rates are being set al levels lower than deposit rates. We view the negative spread problem as one manifestation of the weak financial position of the corporate sector, which underpins the nonperforming loans problem. Ultimately, the cost is reflected in the costs of bank restructuring. Thus, as interest rates fall, the main benefit, in the short term, would be reduced costs for bank restructuring. We hope to explore this further in the next staff report.
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> On October 30 the tax authorities issued regulations that eliminated the tax disincentives for mergers and restructuring. However, decrees on providing debt equity conversions and the associated tax provisions are still outstanding and need to be finalized. We have been told that this should be resolved by the end of this month.
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> Mr. Kapteijn, in his comments about monitoring exchange flows, suggested that the staff should publicize the fact that Fund technical assistance is being provided. That information is in the letter of intent, which is read

carefully by the public and outsiders as they access it through the web. In some sense, that statement is there precisely to achieve the purpose that Mr. Kapteijn had in mind.

The staff representative from the Monetary and Exchange Affairs Department, in response to questions and comments, made the following remarks:

One should not only look at the higher interest rate level to determine the additional cost to bank restructuring; one should also consider, for instance, the exchange rate level. In September, when interest rates were about 10 percent higher than they are now, the negative spreads were adding about $1 billion a month to banking sector insolvency. Now that interest rates have fallen, that rate of increase has declined.

Ms. Lissakers and Mr. Sobel contrasted the bank recapitalization scheme with an earlier "champion" bank scheme. Under the "champion" bank scheme, a small number of private banks would be selected and then recapitalized, while the others would probably be closed in an orderly fashion. It is not clear whether the two schemes are that different. The present proposal, instead of preselecting banks according to administrative criteria, selects banks by using uniform criteria to demonstrate eligibility for participation in the scheme.

In response to comments on why the bank recapitalization scheme focused on banks with CARs of better than minus 25 percent but less than 4 percent of assets, the 25 percent limit was the result of the audits of the first 16 banks, which showed a worse situation than had been expected. These were the banks that one would have expected would have been the "champion" banks, and ones which are still regarded as good banks in Indonesia. Some of these banks had CARs of about minus 20 percent. Looking to find a bottom of the range where there is a clear break to avoid arbitrariness, there was a gap at minus 25 percent between the set of banks which might be thought to be the least bad and the others which are worse. The plus 4 percent was picked because the authorities feel that to move straight to 8 percent capital adequacy by the end of 1999 is too extreme and ambitious. The plus 4 percent to minus 25 percent CAR range covers all those banks which do not have immense capital shortfalls on the end-year requirement by Indonesian standards. Moreover, there are not many banks above 4 percent; most of those are niche banks. Beyond the initial CAR requirement, there are two main additional requirements: (i) produce a business plan showing viability over the next three years; and (ii) eliminate infringements of the regulations on connected lending. On the latter requirement, performance has been mixed. Where there are great breaches of the connected lending limits, banks have been given a limited time period to correct this; otherwise, they will not be eligible for the recapitalization scheme.

As to whether this is the best use of public money, the question is: does one still wish to have a residual private banking sector? The banking sector now comprises the large state banks and those are being restructured. The majority of the costs of the bank restructuring actually go to the large state banks. The aim of the restructuring scheme is to keep the best private banks by giving them a chance, so that there is some residual part of the banking sector in private hands. If one looks at the cost side, restructuring these banks is in fact the least cost solution. If there were blanket guarantees on all depositors and creditors, and if one simply closed the banks, the government would have to cover the entire insolvency. The current scheme involves a joint partnership between the government, who will do the bulk of the recapitalization, and the private sector.

As to whether there are sufficient incentives for the private banks, to some extent it is a zero sum gain. The more the government puts in, the more there are incentives for the private sector to be in. It is not consistent to say that the government has been too generous and then say that there are insufficient incentives. There are a number of ways in which, in fact, the scheme is quite attractive to the private banks. When Bank Indonesia discussed this individually with the first private banks, they had a very positive reaction. Those banks immediately started preparing their business plans to demonstrating their eligibility. The attraction lies in the possibility at the end of three years or in the intervening period for the owners to get their banks back. There are basically two ways in which these incentives apply. First, as part of the program, all the loans which are classified as losses or as doubtful are transferred off the books of the banks at zero price. There is no subsidy element. If the auditors have been too negative about the banks, the recoveries are used to reduce, one for one, the government's shares in the bank. After three years, if there have been recoveries, the government's share holdings, which it takes in exchange for its capital infusion, will be reduced below the original infusion. At that stage, it may be possible for the owners to buy back their bank. Under certain plausible assumptions, it may be quite an incentive for the owners to be able to buy their banks back at that stage. At the end of three years, the government is committed to get a fair valuation for the bank. Essentially, the former owners have the first option to buy it at that fair valuation. Otherwise, it is sold into the market. It is a judgment call whether this is too much of an incentive or not. The package aims to attract owners to put in their own capital, which is the objective of the government, and to stay and maintain their relationship with the banks, with it being hopefully a good use of public funds.

The independent review committee had its first meeting last week in Jakarta to set up the modalities of its operation. They intend to meet again at the beginning of December, at which stage the committee is likely to be formally constituted. By meeting every quarter, the committee hopes to ensure transparency of the process. The committee will have full access to all the officials and all the documents pertaining to any IBRA transaction. The Finance Minister, in particular, has been pressing hard for this committee to meet regularly, and has given it a lot of support. It would be beneficial if the committee has professional advisors, such as an accounting firm. In addition, there is an MAE senior advisor who will be in Indonesia for one to two weeks every month for the next year or so to help in this area.

The banking law, which has been passed, has provided IBRA with certain powers, particularly the powers now to be able to take over and hold assets. There were significant problems relating to IBRA taking over banks' assets. The Fund's Legal Department and MAE were working with the authorities on the banking law around July and August, and became aware that the law had passed into parliament. Between that time and October 16, the law was debated in parliament. We certainly were in close contact with our counterparts, who were lobbying with the parliamentarians. The banking law is a major step forward in a number of areas; for instance, it provides the potential for 100 percent foreign ownership and for appropriate bank secrecy provisions. As far as IBRA is concerned, some elements were not included. In Indonesia, there is a tradition for having relatively short laws and having the specifics added by implementing regulations. IBRA's lawyers are working hard on drafting and implementing regulations. There is a question as to whether you can do that through regulation and elucidation, or whether one should really go back to the law. Clearly, the staff would be more comfortable if the law contained all the necessary measures. Revising the law would take approximately two months.

With regard to the impact on public finances, it was envisaged that the bank restructuring be carried out through bond issues. The authorities could issue indexed bonds linked to the central bank and also market-related bonds. The latter would initially be placed into the commercial banks. There is also the need to compensate designated state banks for deposits which have been transferred to it and which are being transferred to it for the closed banks. This needs to take place in the next month or two, particularly as Bank Negara has received deposits from customers from most of the state banks which have so far been closed. The actual volumes outstanding are not large by international standards, especially given that Indonesia has no domestic debt. MAE has been providing technical assistance on bond market developments to kick-start a bond market. In our next mission, we are again taking an expert with us from the Australian Treasury to give advice on the design of the bonds and how they can be placed. So far, the amounts look manageable.

Mr. Guzmán-Calafell asked how much pressure would the cost of bank restructuring put on the public finances in coming years.

The staff representative from the Monetary and Exchange Affairs Department responded that the gross cost of financing included the insolvency of the banking sector and the bonds which needed to be issued. As IBRA and the asset management unit started working, and later on as the government privatized the banks, there should be substantial offsets. Indeed, the pressure on the public financing was likely to be one of the big incentives to motivate aggressive asset realization and privatization of the banks. Certainly, the costs associated with bank restructuring comprised a significant part of the fiscal deficit. Given that the cost estimate was sensitive to interest rates, if the situation improved, it was possible that the overall net costs would be lower than what was projected. The recent overperformance of the exchange rate suggested that it might be possible that interest rates might come down more rapidly than had been expected.

Mr. Daïri pointed out that the public finances would also be affected by the repayment amount—about 30 percent of GDP. He wondered whether the markets, particularly the domestic markets, would be able to provide financing to the budget for that amount. Was there any indication about the average maturity of the bonds that would be created?

The staff representative from the Monetary and Exchange Affairs Department replied that the initial bonds had maturities of 20 years. It was true that the bonds needed to be amortized. The schedule stated that after a two- or three-year grace period, the amortization would start. The maturity structure of the market-related bonds would most likely be under 10 years, in which case the amortization would be more rapid. There would be a grace period of one to two years as well. When year three was reached, there would be pressures—which the authorities were aware of—that unless there were significant offsets through the realizations and privatizations, the amortizations might kick in to offset further low interest rates. But under certain scenarios, the costs actually turned negative at that point. If the authorities would sell off 60 percent or 70 percent of the banking sector, the offsets might be quite substantial. Although the amounts were not out of line compared to what had been achieved in other countries in banking crisis in the previous 10 to 15 years, particularly in Latin America in the 1980s, such amounts would certainly impact the economy.

Mr. Kapteijn asked whether the new banking law created new obstacles.

The staff representative from the Monetary and Exchange Affairs Department believed that the new law did not create new obstacles. However, a full article-by-article check against the original law had not been done. In the case of Indonesia, the actual body of a law was not all-encompassing, and elucidations and regulations needed to be added. The staff has been assured that elucidations have the full force of law. Thus, once those elucidations were drafted, one could then determine whether the law created any obstacles. Since whatever measure that was. The whole law, including the elucidations, needed to be looked at together.

The staff representative from the World Bank, in response to questions and comments, made the following remarks:

> Mr. Yoshimura asked about the Jakarta Initiative and to what extent thethe task force and the scope of its powers has been defined and widely disseminated. As you know, the task force will use a process of facilitation and mediation under the framework of a voluntary market-driven process. The government has recently issued a decree that outlined very clearly the role and the scope or the authority of the Jakarta Initiative task force. The two main responsibilities and accountabilities it has are to remove the regulatory obstacles and become a one-stop shop where the debtors or creditors can get the authorizations or the obstacles that they need from the various ministries removed. In particular, that would be a framework in which these issues regarding the tax laws can begin to be addressed. The second role or responsibility of the task force is to make a determination of when a voluntary or out-of-court settlement process can go forward, as well as make a determination as to when this is a case that needs to be referred to the public prosecutor, in which case that would fall under the bankruptcy law. Those are the two main responsibilities of the task force.

Just this week, the government convened a large conference on the Jakarta Initiative. There were roughly 1,200 participants, the majority of which were debtors or creditors, and there was a wide dissemination of the process, the rules, and what the government sees as how the Jakarta Initiative would work. It was well attended and quite informative. The decree that the government has issued on the task force is now being widely disseminated. A web site has been established which contains the latest information on what is happening under the Jakarta Initiative and what progress is being made.

There was one other comment on corruption in World Bank projects and some recent press statements. What you are seeing coming out in the press is the result of two Bank missions that looked at the issue of corruption. One focused on public administration reform, the operation of the civil service and disclosure laws, and measures to make the business environment more transparent and, thereby, less prone to corruption. The second initiative looked at what we can do to help improve the processes under our projects in terms of monitoring of the Bank's own projects, improving auditing, and intensifying the Bank's supervision to help eliminate corruption in World Bank projects.

Mr. Kwon made the following statement:

There have been a number of positive developments in Indonesia since the first review of the extended arrangement. These developments reflect the authorities' commitment to, and progress on, the economic program. In some cases, for instance, the exchange rate improvements have exceeded the agreed targets. The strengthening of the rupiah and Indonesia's export performance, together with the easing of inflation and interest rates, reflects the continued movement toward stabilization. This in itself is an important outcome, but these developments, coupled with continued stability, will position Indonesia well for further concerted efforts to get the economy firmly back on track in the long term. The scope for a possible further gradual reduction in interest rates is encouraging, as this should provide for an environment that is more favorable for recovery in the banking and corporate sectors. While not wanting to detract from these welcome improvements, there are a few issues that warrant close attention.

It is those fundamentally difficult structural reforms that remain the obvious challenges in the period ahead. The outlook for the Indonesian banking sector appears to be still quite uncertain. The authorities' strategy to restore the banking system to health by focusing on three central elements—IBRA banks, state banks, and the recapitalization of private banks—seems reasonable. However, even if the strategy is successfully implemented, it is just a starting point for full-scale bank restructuring. It is therefore essential that the authorities move ahead quickly with the current bank restructuring plan. As was mentioned in the staff report, the current plan could help resolve the stock problems of banking sector insolvency, but may not be enough to handle the continued flow problems of losses. For example, according to the audit results of the 16 major banks, they are operating with large negative spreads, which undermine the effectiveness of bank recapitalization.

High interest rates still threaten the real sector, resulting in continued high bankruptcy ratios and increasing nonperforming loans. In this regard, close monitoring and adjustment in bank restructuring plans are essential. As the bank restructuring plans are implemented successfully, more light should be shed on the operational side of the banking sector, which includes the supervisory capacity of the government, as well as the business capacity of private financial institutions. In this regard, I would like to urge the Fund to provide proper support for member countries in need in this area. Technical assistance and manpower training will be the main forms of support.

It is gratifying that agreement has been reached on the sale of assets for the first three banks. It is sensible that this should be done over three years. A tighter timeframe may have meant sacrificing those assets for much lower prices. A three-year timeframe will better allow the asset sales to cover the cost of bank recapitalization. It is important that the delays and uncertainties in reaching this agreement do not undermine IBRA's credibility and ability to carry out its mandate.

Given the continued high number of people living in poverty in Indonesia, recent estimates by the World Bank expect this figure to reach between 35 and 40 million by end-1998. The progress in food security and the recent decline in rice prices are particularly promising. However, it is a little disconcerting that development expenditure was well below target. To the extent that this was attributable to the removal of food subsidies, reflecting better targeting, it is then appropriate. We also appreciate that there is a lead time involved in the effective implementation of any social expenditures. However, the continued rise in the number of people living in poverty reinforces the need for action to be taken in activating social expenditures. We would like to encourage the authorities to follow through on their commitment to accelerate development spending.

One final point I would like to make concerns the proposed shift following the next monthly review to a quarterly review cycle. We seem to have reached a critical stage in Indonesia. It is important to consolidate efforts that have produced welcome signs of improvement on a number of fronts and to pursue, with continued vigor, the more difficult structural reforms. Therefore, the program would perhaps benefit from closer monitoring. I am not suggesting that monthly reviews need to be continued, but I would like to encourage the staff to maintain close relations, particularly in the first couple of quarterly reviews.

In conclusion, I support the proposed decision and wish the authorities well in their continued efforts to tackle the reform agenda ahead.

Mr. Zurbrügg made the following statement:

I share the overall positive assessment of most speakers regarding economic developments in Indonesia since our last discussion. I would like to commend the authorities for their steadfast commitment to implementing the stability-oriented macroeconomic policies and tackling the broad range of structural reforms. This being said, complacency would be premature since the economic and, especially the political situation, remains fragile.

On the macroeconomic side, monetary policy has definitely been successful in controlling inflation and stabilizing the exchange rate. This has allowed some easing of interest rates. However, the strong and unexpected appreciation of the rupiah should be considered with some caution. It would be imprudent to attribute this development mainly to a surge in market confidence. An important driving factor is probably the conversion of substantial amounts of external financing into rupiah. Another may be the discussions on a possible introduction of new exchange rate bands in the near future. Considering that social and political risk continued to remain high, I have some doubt on the sustainability of the exchange rate appreciation. The first special session of the Peoples' Consultative Assembly, scheduled for November 10, 1998, will be an important test in this regard.

Turning to fiscal policy, I concur with many other speakers that it should be more resolutely aimed at stimulating the economy. I regret the delays in development spending, and welcome the authorities' efforts to overcome these problems. Attention should, however, be also paid to the effectiveness of the expenditure programs. Corruption and misuse of public resources are problems that must be dealt with forcefully. In this regard, we welcome the idea to involve members from civil society into the task force that monitors the implementation of the social safety net.

On the issue of food security, the present strategy followed by the authorities seems to be successful. The background note, however, points out that the traditional marketing channels have not yet recovered, and that, unfortunately, the ethnic Chinese-Indonesian traders are still being harassed. This may contribute to explain why, despite the elimination of import restrictions, no private imports of wheat, flour and rice have yet to take place. We would appreciate staff comments on this issue.

On banking sector reform, I welcome the progress on various fronts. Complexities of the reform program are well described in the supplement provided by the staff. As always, success will depend on how the reform measures are implemented. The confusion over the repayment of the liquidity support by two large private banks is a case in point. It is essential that all procedures remain transparent and equitable, and that the authority of IBRA is not undermined. Notwithstanding the importance of restructuring corporate debt for resumption of growth in Indonesia, progress in this key area has been quite slow. The INDRA scheme was only officially launched at the beginning of August. As regards the Jakarta Initiative, I initially shared the doubts expressed by Mr. Yoshimura and Mr. Ogushi, but the clarifications by the World Bank representative were quite elucidating.

I agree with the proposed decision and wish the authorities further success in their reform efforts.

Mr. Eyzaguirre made the following statement:

The stabilization efforts in Indonesia's economy are already showing some positive results. At end-September the decline in output is ending, the inflation rate is declining, the trade account is strengthening, and net international reserves are increasing faster than originally envisaged in the program. In addition, the maintenance of a firm monetary stance has helped to boost market confidence in the rupiah, which continue to be critical for the success of the present program. Nevertheless, despite these promising indicators, the outlook remains uncertain. There are still pending problems in the banking system and corporate sector; unemployment and poverty are still on rise, and there is room for improving the efficiency of the social safety net.

Like staff, I think that policy priority should focus in fostering a recovery in output, consolidating the recent gains in stabilization, while strengthening programs to protect the poor. To that end, fiscal policy should provide a greater stimulus to the economy. I encourage the authorities to correct the delays in increasing development spending, specially on new initiatives in health, education and employment generation, while ensuring transparency with adequate monitoring and budgetary controls.

Fiscal policy should be complemented with a cautious easing of monetary policy. To that end it is encouraging to note the declining pattern of the central banks certificates interest rates, and the parallel reduction in the bank deposits interest rates from an average of 60 percent to 51 percent in the last month, as explained in Mr. Zamani's helpful statement. In addition, the successful introduction of auctions for three-month SBIs in mid-October will help to enhance monetary control. These positive developments, in conjunction with the strengthening of the rupiah and the improvement in the outlook for inflation would serve to underpin this process. Nevertheless, I concur with staff that authorities should remain flexible in their management of monetary policy and stand ready to tighten it if necessary. In fact, last week's pressures against the rupiah underscore this point.

The supplementary information provided by staff on the Indonesian's Banking Sector Developments is most welcome. The lessons drawn from this experience should provide light to address banking issues in other members. In this connection I would like to emphasize my complete agreement with the first bullet point of pa.35 in stressing the key importance of a clear and transparent procedure when the major redistribution of the assets of the country takes place. By the same token, I support the five-year framework envisaged to avoid fire sales.

Turning to bank restructuring, recent actions taken by the authorities for the recapitalization program announced on September 29, as described in Mr. Zamani's statement, are indeed welcome. It is to be hoped that continued strengthening of the rupiah and adequate sales of assets will help to substantially reduce the huge cost of about 30 percent of GDP envisaged for this process. The satisfactory resolution of the recovery of liquidity support and excessive connected lending from the owners of private banks should serve not only to maximize the returns to the government, but also to preserve the independence of the Indonesia Bank Restructuring Agency. In this regard, I share staff view that IBRA should act with maximum of transparency, that its autonomy should be carefully protected and its legal powers fully assured.

Additionally, I strongly encourage authorities to speed up the passage of the new central bank law, and provide the necessary support to build up its capacity to fully enforce and monitor the legal requirements and prudential regulations. In this regard, it is regrettable that this structural performance criterion has not been observed by end-September, but I hope that Indonesian authorities will submit to Parliament the draft law by mid-November as scheduled in table 2 of the main staff report.

Regarding the corporate restructuring, I welcome the progress being made in the implementation of the Jakarta Initiative, including the establishing of the Task Force and the appropriate legal and regulatory frameworks, including the Bankruptcy Reform and the strengthening of the commercial courts. However, authorities should stand ready to take additional actions if this scheme proves not to be sufficient, particularly because of the still uncertain macroeconomic setting.

In the external sector, I welcome the strengthening of the current account reflected in the surplus recorded in the second quarter, and the increase by US$ 1.2 billion of net international reserves, closing the month well above the end-month performance criterion. The recent agreement reached by the Indonesian government and the Paris Club creditors in Paris on September 23 will provide a significative cash flow relief which will help to ease the pressure on the Rupiah. Regarding short-term capital flows, authorities should be very careful in the designing of a prudential reporting system and external debt management. Markets are very sensitive to any signal that can be interpreted as a government's attempt to go back to capital controls.

It is unfortunate that authorities did not comply with the structural performance criterion regarding the complete divestiture of two state enterprises that are presently unlisted. We are aware that market conditions are not favorable. However, this should not serve to delay these efforts, adding credibility in the government's reform agenda while simultaneously helping to buttress the fiscal position.

I welcome the decision to expand the targeted subsidized rice program, with World Bank support, from its current coverage of five million poor families to as many as 17 million, at a very reasonable budgetary cost of 0.25 percent of GDP. Additional efforts should be deployed, such as the supplementary feeding program for children and pregnant women.

With these remarks, Mr. Chairman, I would like to support the proposed decision and wish the Indonesian authorities success in their endeavors.

Mr. Rustomjee made the following statement:

Let me start by thanking the staff for the detailed information provided in the papers under discussion, as well as for this afternoon's update and clarification. They have all been very useful.

First, as with earlier speakers, we are encouraged by the recent positive developments in the Indonesian economy, including the strength of the currency, improvements in the balance of payments position, the better than expected buildup in external reserves, and the moderation in inflation. These are all substantial achievements; in particular, the case of the increased level of exports seems to suggest that supply responses may be beginning to work. I was not a member of this Board when the authorities requested that the staff analyze trade performance. Having heard the staff's responses this afternoon, I recognize it is extremely complex and not an easy issue to get to the bottom of. I would still persist in suggesting that even a brief assessment might be instructive and revealing. I will come back to that on my fourth point in a moment.

Second, we are also encouraged by the decline in food prices, which will have a direct and substantial impact on the poor. To a large extent, all of these positive developments reflect the Indonesian authorities' commitment to sound policies. As Mr. Zamani reminded us in his helpful statement, we commend the authorities for their achievements thus far. As a result of the government's strong commitment, virtually all performance criteria have been observed. Perhaps more significantly, there are other signs that macroeconomic consistency is starting to gain credibility, reflected by the capital account surplus in the second quarter of 1998 and the recent increase in the Jakarta composite stock price index.

Third, the recovery is fragile. In this regard, we support the fiscal approach being pursued by the authorities. Having just arrived from the World Bank, I had to reassure myself several times that it was indeed Fund staff and not Bank staff calling for increased fiscal stimulus. Perhaps it has something to do with the revolving doors in the tunnel between the Bank and the Fund.

Fourth, Mr. Daïri had a question on when the appreciation of the rupiah could expect to begin impacting competitiveness. In a sense, it is the other side of the coin of what Mr. Sivaraman was asking. It is an issue I will raise bilaterally and I will not detain the Board on this issue. It will be raised again when we deal with other economies that are having sharp fluctuations in their currency.

Fifth, we support the authorities' efforts to provide rice—the country's main staple—at affordable prices, while expanding the social safety program because an increasing number of the population is experiencing a significant erosion in real income. The background paper indicates that the World Bank is being instrumental in this regard, and we urge the authorities to improve the effectiveness of the program.

Finally, I fully support the proposed decisions.

Mr. Daïri pointed out that there was some speculation that when the rupiah reached 7,000 per U.S. dollar, the economy would start to suffer. In that context, he urged the staff to look both ways with regard to their recommendations on the monetary policy stance. More specifically, monetary policy should be adjusted not only when the exchange rate appreciated but also when it depreciated.

Mr. Ismael made the following statement:

It is encouraging to read of further progress in the efforts to stabilize the economy of Indonesia, with most financial indicators moving broadly in the right direction. Noteworthy is the strengthening of the Indonesian rupiah. As noted by previous speakers, it is a welcome development as it is indicative of a firming of confidence by the market. I would, therefore, like to join others in commending the Indonesian authorities for their continued strong policy implementation which together with increased external financing have been critical to the achievement of the recent positive development. However, and as to be expected, the economy remains weak. In the circumstances, I welcome the authorities' objective of giving priority to policies that will foster growth, while consolidating stabilization and strengthening programs to protect the poor.

The use of fiscal policy to provide greater stimulus to the economy in the second half of 1998/99 is certainly appropriate. I am glad that both the staff and the authorities agree on this issue. However, it is not clear to me how this stimulus will be achieved since in both the staff report and the letter of intent, I note that development spending is likely to be less than budgeted, and that current expenditure is projected to be below program, as subsidies will be reduced.. Staff comments on the apparent contradiction between the objective of a fiscal stimulus that is intended, and the actual development as regards spending will be appreciated.

On monetary policy, I agree that developments in the financial sector call for an easing of policy. In particular, I share the view that a gradual decline of interest rate would seem appropriate, at the present time, especially, in view of its potential contribution to a recovery of economic activity. Nevertheless, as noted by others, this policy should be implemented with flexibility, with an eye on developments in the exchange rate market.

I am also encouraged by the progress made in the restructuring of the banking sector. Much has been done, especially over the past three months, but, many challenges remain. The most important one being the implementation of the recapitalization plan. The outline of the plan provided in the staff report seems ambitious, but it is important that all the elements be implemented according to the time table to ensure a full recovery of the banking sector which is of critical importance to the success of the stabilization program.

On corporate debt restructuring, with the Jakarta Initiative coming into operation, it is important that the regulatory framework be put in place so that the restructuring process can start soon. In that respect, I noted some doubts regarding the pace of progress in this area, can the staff comment on the progress achieved up to now, and how do they view further progress in this area.

With these comments, I support the proposed decisions.

Ms. Wang made the following statement:

It is encouraging that further progress has been made with stabilization since the last review. The Indonesian rupiah has been further strengthened, inflation has moderated considerably, and the output decline decelerated in September. These favorable developments have ignited the hope that the economic slump in Indonesia is bottoming out. The Indonesian authorities should be commended for their continued good policy implementation. However, they are still far from the point where some complacency could be allowed. As the staff pointed out, the situation remains fragile, the economy is still extremely weak, and unemployment and poverty are still on the rise. Greater efforts are needed to bring the economy back on the track of sustained recovery. I agree with the thrust of the staff's appraisal, and would like to concentrate my comments on several issues which I think are important.

First, on the exchange rate and monetary policy. We welcome the recent reduction of interest rates which will alleviate the burden of banks and corporations. Tight monetary policy is one of the most important contributing factors to the appreciation of the rupiah in the past few months. We agree with the staff that the stabilization and strengthening of the rupiah have created some room for a further cautious easing of monetary policy. However, the recent depreciation of rupiah indicated the fragility of the recovery and it is worth pointing out that the further strengthening of the rupiah will be a very good indicator for the restoration of confidence, and will facilitate the restructuring of the banking and corporate sectors. Therefore, the easing of monetary policy has to be cautious, and the authorities should be ready to tighten policy if the exchange rate weakens or there are signs that inflation is not declining as envisaged.

Second, on fiscal policy. The enhanced efforts in speeding up social and development spending is welcome. In order to provide the necessary stimulus to the economic recovery and further alleviate the suffering of ordinary people, the authorities are encouraged to do their utmost to implement fiscal expenditure in line with the program.

Third, on the food situation. The authorities should be commended for their effective implementation of the seven point program which led to the recent decline in rice prices. It is also encouraging to learn that it is possible to prevent further significant increases in prices during the coming lean season. However, the critical importance of the food situation with regard to social stability requires continued vigilance for any possible unstable factors. In this context, we join the staff in urging the authorities to make every effort to ensure the timely signing of the contracts for the remaining amounts of the needed imports, and the timely fulfillment of all the food importing contracts.

Fourth, encouraging progress has been made in banking sector and corporate sector reform. We welcome the approval of the amendments to the baking law which will facilitate the restructuring process by strengthening the legal power of the IBRA and its Asset Management Unit. We welcome the new announcement about arrangements for the liquidity problem. Similar flexibility should also be exercised with regard to the implementation of the privatization plan due to similar considerations.

With these remarks, we support the proposed decisions and wish the authorities further success.

Mr. Palei made the following statement:

Yesterday marked the passing of one year since the Fund approved the Indonesian program. Unfortunately, while in Thailand and Korea economic recovery seems to be a matter of perseverance and luck, there is still little optimism that Indonesia will come out of its crisis any time soon.

Among macroeconomic developments the staff point to the recent strengthening of the Rupiah as a sign of improved market sentiments and also as a partial return of confidence in the Indonesian recovery. Many observers, though, notice that the official inflows of capital are the main determinants of the exchange rate in a thin market. In fact, Mr. Neiss confirmed that there had been a significant increase in official inflows in the last several weeks. To be on the cautious side, one should agree that the recent appreciation of the Rupiah can hardly serve as an indicator of a change for the better in the attitude of private market participants. It is not surprising that, in response to recent social tension and reflecting the fragility of current situation, the exchange rate exhibited large gyrations. In any situation, large swings in the exchange rate contribute to a high level of uncertainty about the economic prospects in Indonesia.

Similarly, the market participants remain skeptical about prevailing interest rates. Their "wait and see" attitude to a large extent depends on the exchange rate and inflation outlook. The staff say that the latter has improved, but in their paper they did not elaborate on the likely price developments. Today, Mr. Neiss told us that, in October, the price level actually declined, and that for the next year the staff now envisage inflation of about 10 percent. Given the improved inflation outlook, interest rates of 50-60 percent seem to be unnecessarily high.

Current developments in the fiscal area also point to the need for a faster decrease in interest rates. In my opinion, the fiscal deficit is likely to remain relatively small due to logistics problems with the distribution of assistance to vulnerable groups of people and due to a general lack of institutional capacity in this area. In addition, the appreciated Rupiah, will probably affect the fiscal outcome through lower rice subsidies. Overall, it is unlikely that the authorities can "catch up" with the program target for the fiscal deficit. There are legitimate reasons not to press the authorities to achieve the program target for the fiscal deficit. Although this chair has unambiguously expressed its support for the provision of fiscal stimulus in Indonesia and, especially, for the additional expenditures on the social safety net, it is important to ensure the appropriate targeting and efficiency of such expenditures. If social assistance can not be delivered efficiently, there is no need to advise the authorities to achieve the high level of fiscal deficit specified in the program. The emphasis placed by some Directors on the importance of fiscal stimulus for economic recovery to me seems to be an overreaction. Since the Indonesian crisis is now structural, the primary role of the fiscal deficit is determined more by the need for protection of the most vulnerable and less by the fiscal stimulus it provides. Instead, the policy mix should be tilted in favor of lower interest rates sooner rather than later.

The improved inflation outlook and much tighter than envisaged fiscal policy are not the only arguments in favor of a faster decrease in interest rates. According to the staff, through an existing negative spread between deposit and lending rates, excessively high interest rates impose on the budget an additional burden of recapitalization of the banking sector. I would argue that, even more importantly, too high interest rates are one of the main impediments to the participation of the private sector in the corporate debt restructuring under the Frankfurt agreement.

Indeed, a lack of progress in corporate debt restructuring is a matter of special concern. To a certain extent it can be explained by the extreme uncertainty in the macroeconomic area. Still, it is frustrating to see that, although three months have passed since the Frankfurt agreement was put in place, as of the end of October, not a single case benefitted from participation in this scheme. There is hope that the Jakarta Initiative could help to jump start the corporate debt restructuring, but as Mr. Yoshimura and Mr. Ogushi said in their Statement, there are few details in the staff papers about its goals, structure, and functioning. I wish the staff had paid more attention to the Initiative in their report. I would appreciate it, if the staff could disseminate available information on the Initiative to the offices of the executive directors.

I understand the difficulties the authorities are facing in choosing the right timing for disposal of equity assets received from the banks. It is quite a challenge to find the appropriate balance between maximization of revenue from the sales of equities and the pressing need for cash. I support the staff in their pragmatic approach to this issue and welcome the agreement reached with the authorities. It is important for the authorities to avoid decisions with questionable contributions to efficiency. There were reports in the media about the strong political pressure on the authorities to launch a campaign of a grand-scale redistribution of wealth in the country. It seems that the Cooperatives Ministry is particularly active in its requests for the allocation of equities to broad groups of Indonesians. The staff should remain watchful of developments in this area and encourage the authorities to resist the temptation to follow the populist route of politically-induced property rights reassignments.

> I support other Directors in their concern about the governance issues in Indonesia. At the same time, realizing the importance of the social safety net, I would like to raise one more related issue. I saw some references in the press to the fact that the Indonesian officials are so afraid of being accused of corruption that they are reluctant to make timely decisions on the disbursement of aid. I wonder if the staff could comment on how legitimate such concerns are.
>
> Finally, Mr. Chairman, on previous occasions I have already expressed my hesitance to tie the Fund disbursements to the timing of privatization, especially when particular companies are specified in the Fund's conditionality. I do not consider the performance criterion that has not been met to be essential for the Indonesian program and, hence, support the completion of this review. I was also in favor of the switch to quarterly Board reviews from the beginning of next year, but consider the proposal by the staff for a period of bi-monthly reviews as an acceptable compromise.

The Director of the Asia and Pacific Department said that he agreed that attention needed to be given to export performance in the context of the ongoing review of the macroeconomic framework of the balance of payments and the financing gap. The staff would examine both the quantities as well as prices to come to an assessment. With regard to Mr. Daïri's question, the exchange rate has not reached a level at which further appreciation would be a concern with regard to competitiveness. The rupiah's depreciation has been larger than the currencies of the other crisis countries, and Indonesia has had a higher inflation rate. The currencies of the other crisis countries—Thailand, Philippines, Malaysia, and Korea—have depreciated in real terms by 25 to 30 percent, compared to their peak in the summer of 1997. To match that level of depreciation, the rupiah would have to be in the range of 6,500 to 7 ,000 per U.S. dollar, but that did not necessarily mean that that was the range to pick. The correct approach to the problem of excessive appreciation was to look at the medium term scenario and make a judgment as to what was the appropriate current account position for Indonesia. Then, the real exchange rate would be estimated and be made consistent with that current account position. That real exchange rate would then need to be translated into a rupiah dollar rate. Obviously, given that that process involved some judgment, one could only come up with a range. However, the rupiah was still not in that range; that meant that the relaxation of monetary policy needed to be cautious.

In response to the comment that the staff should pay more attention to corporate debt restructuring, the Director pointed out that it was the Fund staff who had proposed the Jakarta Initiative. However, under the cooperation arrangements with the World Bank, the Jakarta Initiative was now the primary responsibility of the World Bank, while the Fund was concentrating more on bank restructuring. However, that did not mean that the Fund would neglect the area of corporate restructuring. With regard to the calls that more information on corporate debt restructuring be made available, the staff would convey that request to the World Bank.

Mr. Harinowo made the following concluding remarks:

> First, the Indonesia authorities welcome the need for intensive monitoring in the form of a quarterly review with monthly missions. However, the staff indicates that there is another option—bimonthly reviews. Thus, it

would be helpful if the staff discussed this option with the authorities during the next mission.

Second, on the issue of privatization, the authorities have been very committed to seeding up this activity. In fact, they have already completed the master plan for the next ten years, with the assistance of Solomon Brothers.

Third, the current banking law has been amended in areas such as foreign ownership and granting more power of IBRA. Moreover, that law is expected to revised completely in 2000.

Finally, on behalf of the Indonesian government and its people, I would like to once again thank the Board, management, and the staffs of the Fund and the World Bank for their tireless efforts and dedication.

The Executive Board took the following decisions:

Review under Extended Arrangement

1. Indonesia has consulted with the Fund in accordance with paragraph 3(c) of the Extended Arrangement for Indonesia (EBS/98/130, Sup. 3, 8/27/98).

2. The letter dated October 19, 1998 from the State Coordinating Minister for Economy, Finance, and Industry, with the attached Memorandum of Economic and Financial Policies shall be annexed to the Extended Arrangement, and the letter dated July 29, 1998 from the State Coordinating Minister for Economy, Finance, and Industry, and the memorandum attached thereto, shall be supplemented and modified by the letter dated October 19, 1998, (with its attached memorandum).

3. Accordingly, the limits and floors for end-December 1998 referred to in paragraph 3(a) of the extended arrangement shall be as specified in the table to the memorandum attached to the letter dated October 19, 1998.

4. The Fund decides that the second review contemplated in paragraph 3(c) of the Extended Arrangement for Indonesia is completed and that, notwithstanding the non-availability of data for the performance criterion for end-September on the central government balance set forth in paragraph 3(a)(ii) and the non-observance of the structural performance criteria set forth in paragraphs 3(b)(i) and 3(b)(ii) of the Extended Arrangement for Indonesia, Indonesia may continue to make purchases in accordance with the provisions of the Extended Arrangement until November 15, 1998. (EBS/98/174, 10/19/98 and Sup. 1, 10/23/98).

Decision No. 11824-(98/114), adopted
November 6, 1998

Exchange System

Indonesia maintains a multiple currency practice arising from a foreign exchange subsidy for rice imports subject to approval under Article VIII, Sections 2(a) and 3. The approval for the retention by Indonesia of the multiple currency practice, granted pursuant to Executive Board Decision No. 11718-(98/51), is hereby extended until March 31, 1999. (EBS/98/174, 10/19/98 and Sup. 1, 10/23/98)

Decision No. 11825-(98/114), adopted
November 6, 1998

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/98/113 (11/4/98) and EBM/98/114 (11/6/98).

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAM/98/189 (11/3/98), by Advisors to Executive Directors as set forth in EBAM/98/181, Supplement 1 (11/3/98) and EBAM/98/189 (11/3/98), and by an Assistant to Executive Director as set forth in EBAM/98/189 (11/3/98) is approved.

APPROVAL: February 21, 2001

Shailendra J. Anjaria
Secretary