June 21, 2001
Approval: 6/28/01

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 00/11

9:30 a.m., February 2, 2000

Contents

EXECUTIVE BOARD ATTENDANCE

M. Camdessus, Chairman
S. Fischer, Acting Chairman
E. Aninat, Acting Chairman
S. Sugisaki, Acting Chairman

Executive Directors	**Alternate Executive Directors**
S.M. Al-Turki	A.S. Alosaimi
A. Barro Chambrier	D. Ondo Mañe
T.A. Bernes	P. Charleton
	P.R. Fenton, Temporary
A.G. Carstens	H. Oyarzábal
R.F. Cippà	W. Szczuka
	R.J. Singh, Temporary
	W.-D. Donecker
	W. Merz, Temporary
	A.G. Zoccali
	J. Spraos
	G. Schlitzer, Temporary
	C.A.E. Sdralevich, Temporary
	C. Harinowo
V. Kelkar	
W. Kiekens	J. Prader
	A. Jacoby, Temporary
	Å. Törnqvist
K. Lissakers	M. Sobel, Temporary
	G. Bauche
	B. Couillault, Temporary
A. Mirakhor	M. Daïri
	C. Rustomjee
	A. Lushin
	L. Palei, Temporary
S. Pickford	S. Collins
M. Portugal	R. Junguito
A.S. Shaalan	A.F. Al-Faris
G.F. Taylor	I.M. Woolford, Temporary
Wei Benhua	Ms. Jin Q.
	Luo O., Temporary
J. de Beaufort Wijnholds	Y.G. Yakusha
	I.C. Ioannou, Temporary
Y. Yoshimura	H. Toyama

S.J. Anjaria, Secretary
A. S. Linde, Acting Secretary
P.J. Kunzel, Assistant
G. Nkhata, Assistant
S. Soromenho-Ramos, Assistant

Canada—2000 Article IV Consultation
Staff representatives: Goldsbrough, WHD; Dunaway, WHD; Kincaid, PDR; Johnston, MAE

Medium-Term Planning Options and Resource Estimates
Staff representatives: Conrad, OMD; McClellan, OMD

Mauritania—Enhanced Initiative for Heavily Indebted Poor Countries—Decision Point
Staff representatives: Alonso-Gamo, MED; Boote, PDR; Tuluy, IBRD; Saponara, IBRD

Also Present
IBRD: K. Hollifield, Office of the Executive Director; M.J. Saponara, H.A. Tuluy, Africa Regional Office. African Department: S.L. Rothman. Asia and Pacific Department: R.A. Elson. European I Department: A. Leipold, S.M. Thakur. European II Department: O. Havrylyshyn. External Relations Department: G. Hacche, Deputy Director; F. Mboto. Fiscal Affairs Department: M. Asakawa, K.-Y. Chu. Human Resources Department: J.P. Kennedy. IMF Institute: A.M. Kim. Legal Department: W.E. Holder, Deputy General Counsel; R.L. Weeks. Middle Eastern Department: P. Chabrier, Director; D. Burton, Deputy Director; P. Dhonte, Deputy Director; P. Alonso-Gamo, S. Bazzoni, V. Fichera, M.M. Lazare, N.A. Ltaifa, J. Rahman, M. Zavadjil. Monetary and Exchange Affairs Department: S. Ingves, Director; J. Begum, K. Driessen, H. Huang, R.B. Johnston, M.E. Kepner, M.B. O'Brien, A. Ouanes, P.C. Ugolini. Policy Development and Review Department: J.T. Boorman, Director; A.R. Boote, T.W. Dorsey, U. Jacoby, G.R. Kincaid, S. Singh. Research Department: A.J. Tweedie. Secretary's Department: P. Gotur, B.A. Sarr. Statistics Department: E.W. Saunders. Technology and General Services Department: S.H. Choi, P.P. Guilmard. Treasurer's Department: J.E. Blalock. Western Hemisphere Department: C.M. Loser, Director; M.E. Bonangelino, Deputy Director; D. Goldsbrough, Deputy Director; V.B. Arora, L.A. Cardemil, M.D. Cerisola, P.R. De Masi, S.V. Dunaway, M.D. Kaufman, M. Leidy, A. Matzen, G. Ramirez. Office of the Managing Director: D.A. Citrin, J.A.P. Clément; Office of Budget and Planning: E.-A. Conrad, Director; A.E. Calamitsis, F.J. Gaitan, J. Hudson, P.J. McClellan, P.J. McPhillips, H.L. Mendis, M.S. Obias-Bonnefoy, C.L. Vehorn, T. Wolde-Semait; Office of Internal Audit and Inspection: R. Munoz, Director; A. Coune. Advisors to Executive Directors: M.A. Ahmed, J.A. Chelsky, J.A. Costa, I. Dragulin, J.C. Estrella, S.S. Farid, O. Himani, E.J.P. Houtman, N. Jadhav, J. Jonáš, J.M. Jones, E. Jourcin, M.E. Kandil, M.F. Melhem, H. Mori, Y. Patel, M.R. Shojaeddini, S. Thiam, T. Turner-Huggins, F. Zurbrügg. Assistants to Executive Directors: S.A. Bakhache, P.A. Brukoff, P. Cabezas, I.- K. Cho, T. Elkjaer, E. González-Sánchez, K. Harada, S. Hinata, C. Josz, A. Kapteijn, B. Kelmanson, K. Kpetigo, D.H. Kranen, Liu Z., A. Maciá, W.C. Mañalac, Y. Moussa, D. Nardelli, J. Nelmes, Peh K.H., M. Pérez dos Santos, V. Rigász, S. Rouai, J. Schaad, Siti Mariam Mohd. Yusof, A. Sutt, Vongthieres O., M. Walsh, R.P. Watal, I. Zakharchenkov.

1. EXECUTIVE DIRECTOR

The Executive Directors welcomed Ms. Jin as Alternate Executive Director for the People's Republic of China.

2. CANADA—2000 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 2000 Article IV consultation with Canada (SM/99/314, 12/29/99; and Cor. 1, 1/24/00). They also had before them a staff paper on selected issues in Canada (SM/00/6, 1/11/00) and a financial system stability assessment—report on observance of standards in the financial system (FO/DIS/00/2, 1/4/00; and Sup. 1, 1/4/00).

The staff representative from the Western Hemisphere Department submitted the following statement:

> Since the staff report (SM/99/314, 12/29/99) was issued, new data released indicate that the unemployment rate remains unchanged, while core inflation remained stable at about 1.5 percent through December. Over the past few weeks, the Canadian dollar has appreciated, while interest rates have risen moderately in Canada, although they still remain below those in the United States. The thrust of the staff appraisal is unchanged by these developments.
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> Robust growth in employment offset a rise in the labor force, keeping the unemployment rate stable at 6.9 percent in December. All the increase in employment was in full-time jobs. These gains were also evenly distributed across age groups, with youth and adult male employment rising markedly. As a result, employment grew by about 2.75 percent on average in 1999, broadly in line with its growth rate in 1998, but significantly above the 1.5 percent average growth rate recorded in 1992–97.
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> Core consumer price inflation remained largely unchanged in December 1999, rising by about 1.5 percent on an annual basis, while the overall CPI rose by about 2.5 percent, primarily reflecting higher energy prices. On an average annual basis, core inflation rose by 1.4 percent in 1999, compared to 1.1 percent in 1998; the overall CPI rose by 1.75 percent in 1999, compared to 1 percent in 1998.
>
> Stronger economic conditions in Canada and in world commodity prices have contributed to an appreciation of the Canadian dollar to around 69 U.S. cents in late January. Interest rates in Canada have risen since end-1999 by about 20 and 40 basis points at the short and long end of the yield curve, respectively, broadly in line with those in the United States. The negative differential between Canadian and U.S. interest rates has remained largely unchanged since late December, with short-term Canadian interest rates about

40 basis points lower than in the United States and long-term Canadian interest rates about 20 basis points lower.

In a recent speech, Bank of Canada Governor Gordon Thiessen said that the Bank will begin publishing updates to its Monetary Policy Report (currently published in May and November). The updates will be released in February and August in order to increase the flow of information between Monetary Policy reports to market participants.

Mr. Bernes submitted the following statement:

Once again, the staff has produced a thorough review of Canada's economic performance and policy options and my authorities would like to convey their appreciation. They broadly concur with the thrust of the staff's recommendations. As well, Canada was pleased to be one of the first countries to participate in the FSSA surveillance process. As the program is in a pilot stage, the FSSA involved considerable work for all of those involved. Much was learned by the staff at both the government of Canada and the IMF, however, and we hope that the experience will contribute to enhancing the peer review process internationally. We will have more to say on the lessons learned from our participation in the FSSA when the Board reviews the pilot project.

The Canadian economy has rebounded strongly since late 1998, supported by strong economic fundamentals—low inflation and balanced budgets. The strengthening in growth is owing to a surge in domestic demand and improved world economic conditions. The pick-up in domestic demand growth in 1999 coupled with robust export demand has provided for more balanced real GDP growth and put the Canadian economy on a more solid footing.

Canada's strong economic performance has been reflected in a healthy labor market. Nineteen-ninety-nine marked the third consecutive year of strong employment growth, with 354,900 jobs created in 1999—full-time jobs increased 438,300. Since the end of 1996, almost 1.2 million jobs have been created. This has brought the unemployment rate down from near 10 percent at the end of 1996 to 6.9 percent in November and December, its lowest level since August 1981. The last time it was below 6.9 percent was in March 1976.

Mainly reflecting higher fuel prices owing to the strong increase in world oil prices, inflation has picked up somewhat in recent months, but core inflation is still below the mid-point of the target range. In December, headline consumer price inflation was 2.6 percent and core inflation (excluding food, energy, and the effect of indirect taxes) was 1.6 percent. Wages, the largest component of production costs, rose more strongly in 1999; however, a pick-up in labor productivity resulted in a fall in overall unit labor costs.

Canada's fiscal situation has improved markedly in recent years. The federal government recorded a budget surplus of $2.9 billion in 1998–99, following a record $3.5 billion in 1997–98, the first surplus in 28 years. These surpluses, together with economic growth, have put the debt-to-GDP ratio on a strong and permanent downward track. Provincial and territorial governments have also taken important steps to improve their fiscal positions. Six provincial governments and one territorial government reported budget surpluses in 1998–99.

The information received since early November when the IMF consultation took place, suggests that there is even greater momentum in the Canadian economy because of greater strength both in the world economy, especially in the United States, and in global commodity markets.

Recent international trends, including stronger commodity prices, together with the stronger spending of both households and businesses, have prompted most forecasters to revise their projections for Canada's growth upwards. The latest private-sector average forecast is for economic growth of 3.5 percent this year and 2.9 percent in 2001. The unemployment rate is expected to decline slightly, averaging 6.8 percent in 2000 and 6.7 percent in 2001. CPI inflation is expected to remain near to the mid-point of the target range of 1 to 3 percent, jointly set by the government and the Bank of Canada.

A firm foundation has been put in place, but there are new challenges to face.

The accomplishments above, while notable and welcome, do not represent the end of the road. There remain significant policy challenges to be addressed, albeit ones of a preferable nature to those confronted in the past decade. The issue now is how to maintain and build upon these achievements.

The challenge for monetary policy is how to operate as the economy gets close to the full use of its production resources. Based on typical measures of production potential, the level of economic activity in Canada is currently in the vicinity of full capacity. Ideally we want to see the economy operating at a level that is as close as possible to full potential. At this level, economic activity will expand at as rapid a pace as is sustainable over time while ensuring a low and stable rate of inflation. Unfortunately in practice it is difficult to estimate precisely where this ideal operating level is. This is particularly true after a period of business restructuring, rapid technological change, and strong business investment in plant equipment, such as happened in Canada during the 1990s. These developments have raised the economy's production capacity, but we cannot be sure by how much. Consequently, monetary policymakers will want to test the productive capacity of the economy, while being on guard to preserve low inflation.

In this context, the Bank of Canada is closely monitoring a wide range of indicators that can help it assess the extent of present and future pressures on capacity and on inflation. And it will respond promptly and firmly if signs of pressure on capacity or on inflation emerge. These indicators include unanticipated movements in current inflation, changes in expectations of future inflation, the growth of money and credit, and information gathered from the Bank's regular contacts with businesses across Canada. The Bank will also pay careful attention to inflation developments in Canada's main trading partners with a view to preventing any undesirable spillovers.

In order to improve the budget consultation process, the federal government presented five-year economic and fiscal projections in its Fall Update. The key objective was to re-orient public debate away from the surplus numbers and focus it instead on the uses of the emerging surplus.

The staff has recommended that Canada use its budgetary surpluses to reduce its debt and cut taxes. As indicated in the Fall Update, this is what we intend to do. We will continue to include in our budget plans, a Contingency Reserve for risks in economic forecasts and unpredictable events, which if not needed, will be applied to reducing the debt. Within five years, we expect the debt-to-GDP ratio to be under 50 percent, compared to its recent peak of 71 percent in 1995–96. In the upcoming budget, we will set out a multi-year tax relief plan. However, both the staff and, the economic literature in general, are relatively silent on how fast debt should be reduced and to what level. The same is true for taxes. We would encourage the IMF to examine these issues in more detail.

The staff also provides a useful discussion of the key problem areas in Canada's tax system. We agree that implementing remedies to these problems should be one of the top priorities when allocating the fiscal dividend. The government is committed to reducing taxes to secure gains in economic efficiency that promote strong and sustained economic growth. We agree with the staff's view that the absence of full indexation of the personal income tax system for inflation, the relatively low thresholds at which marginal tax rates apply, and the marginal tax rate levels themselves are areas to be addressed. As noted in our discussions with the staff, lowering corporate tax rates over time offers the potential for substantial efficiency gains and the distortionary effects of differential corporate tax rates can be addressed in part by lowering the basic corporate rate.

Although longer-term forecasts are appropriate for debate and planning, the uncertainties inherent in such forecasts are too great to commit these surpluses in one fell swoop. As a result, we will continue to take decisions within a two-year rolling budget plan, committing only those resources that are available in the short term.

National savings rates in Canada, on a national accounts basis—savings by households, businesses, and governments collectively—have increased noticeably since 1992, mainly because of improvements in government fiscal positions and corporate profits. This has occurred even though household savings rates have continued to decline. After a substantial reduction in the early 1990s, Canada's national savings rate has now recovered to a level similar to that of the major European nations and is above that of the United States.

The decreases in household savings rates have tended to coincide with increases in the net worth of households, in part because of capital gains. This latter development may have reduced the perceived need of households to save from disposable income, as their stock of wealth was already rising. Among the G-7 countries, the most notable increases in net worth during the 1990s have occurred in Canada, the United States, and France.

The recent declines in household savings rates in industrial countries during the 1990s have also, in general, coincided with improvements in fiscal balances. This suggests that sustained improvements in government financial balances can lead households to expect lower future tax obligations and decrease the component of their savings intended for future tax payments. Empirical evidence for Canada suggests that 50 to 60 percent of a persistent improvement in the government sector's fiscal situation would be matched by lower household savings.

The staff notes the high degree of openness of the Canadian economy and the high degree of integration with the U.S. economy (Box 2). We would like to reiterate in somewhat more concrete terms than the staff why this does not undermine the case for a flexible exchange rate regime in Canada. The key point is that there are important structural differences between the economies of the United States and Canada which mean that Canada is well served by a flexible exchange rate. For example, commodity production accounts for a much larger share of economic output in Canada than it does in the United States. Also, Canada is a major net exporter of non-oil energy and other primary or semi-transformed commodities.

Consequently, changes in commodity prices have a much different impact on the terms of trade in the two countries. For example, at one point during the recent period of world commodity price weakness following the Asian financial and economic crisis, the terms of trade declined by 6 percent in Canada, while they rose by 5 percent in the United States. As a result, the value of the Canadian dollar declined vis-à-vis the U.S. dollar. In turn, this helped to sustain economic activity in Canada by stimulating U.S. demand for our goods and services and lowering Canadian demand for foreign goods and services. This is an example of a long-standing empirical truth: the shocks that affect the Canadian economy are often quite different (asymmetric) than those affecting the U.S. economy creating an important role for the exchange rate to play as a "shock absorber."

The government has introduced significant reforms to the employment insurance system. The government recognizes that further reforms could improve the functioning of the labor market, but prefers to wait for a full assessment of the impacts of the reforms that have already been implemented before introducing new ones. The government has done some research on the experience-weighting of employment insurance premiums and could consider it as an option in the future.

The government's commitment to extend and make more accessible Employment Insurance benefits for parental leave forms a key part of the overall strategy to invest in Canada's children. Contemporary research points to the critical importance of the early relationship between an infant and its parents. These changes will provide greater flexibility and more choices to parents of newborn or newly-adopted children. Combined with past and future investments in the National Child Benefit, and a new National Children's Agenda to be developed among the federal, provincial, and territorial governments, the enhanced EI parental leave benefits will contribute to ensuring that Canada's children will develop the abilities to succeed in being ready to learn throughout life.

We found the peer review process to be useful in evaluating our financial system and regulatory framework.

The self-assessment portion of the review was a catalyst for Canada's supervisors to assess observance to international core principles, including the Basle Core Principles of Effective Banking Supervision and the CPSS Core Principles on Systemically Important Payment Systems, among others. By assessing compliance with a set of such principles, the FSSA review efficiently provided useful and meaningful advice to Canada. This review of core principles was a useful exercise for regulators. As well, the review of regulatory approaches with experienced peers from other countries provided us with valuable advice and suggestions.

Not surprisingly, we concur with the overall assessment that Canada possesses "a stable and highly advanced financial system that is among the soundest in the world, supported by a well-developed regulatory framework that conforms in most respects with international standards."

It is to be expected that a peer review of this type will come up with some challenges the country faces. The FSSA review highlighted a few such issues for Canada, including:

The call for more flexible ownership rules that could facilitate cross-border mergers with foreign institutions.

There are currently no foreign ownership restrictions on financial institutions in Canada. However, the government is maintaining the rule that our largest financial institutions must be widely held. A single shareholder, or shareholders acting in concert, can own no more than 20 percent of voting shares, and 30 percent of non-voting shares. This rule applies equally to domestic and foreign investors.

The suggestion to strengthen coordination and harmonization of the different federal and provincial regulatory and supervisory frameworks.

We generally agree with the recommendations on the need to reduce regulatory complexity and duplication and to undertake work on the efficiency costs of the current regulatory arrangements. However, the division of responsibility for financial sector regulation in Canada stems from the Canadian constitution. A number of mechanisms, formal and informal, have been developed to manage this system. From a safety and soundness perspective, Canadian authorities are of the firm view that there are no significant gaps or problems regarding the regulation of financial institutions. Regarding securities regulation, the Canadian Securities Administration has intensified efforts over the past three years to establish a “virtual” national securities commission. Finally, we continue to explore ways to improve cooperation and coordination between the provincial and federal regulators and supervisors.

The migration of large-value payments from the Automated Clearing and Settlement System to the large Value Transfer System should be accelerated.

The migration of large-value payments from the ACSS to the newly-established LVTS is still in a transition phase. LVTS has been in operation for less than a year and large-value payments are still migrating to it. Moreover, there is a working group within the Canadian Payments Association to promote and manage the migration of large-value payments from ACSS to LVTS.

Canada strongly supports the publication of Article IV reports and has agreed to participate in the pilot project on transparency.

Mr. Bernes, extending his statement, thanked the Board and the staff for the productive Article IV process. Technical discussions had taken place with the Bank of Canada and the Department of Finance, cutting across a range of issues. The Bank of Canada's outside Board of Directors was so impressed with the work of the IMF staff that it had requested the staff to appear before it.

Canada had been a strong advocate of transparency and publication and was participating in the Article IV pilot project, and also intended to publish both volumes of the Financial System Stability Assessment (FSSA) report, Mr. Bernes added. Such publication provided for a better debate and better reactions in the markets.

Mr. Pickford and Mr. Burgess submitted the following statement:

> There appear to be few clouds on the economic horizon. The Canadian economy is in excellent shape: growth is strong, inflation is low, the current account is in surplus, unemployment is at its lowest level since the early 1980s and, for the first time in almost two decades, the constraints imposed by intractable government debt and deficits appear to have lifted. This is an impressive performance by any standards, and one for which the authorities deserve congratulations.
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> The debate on fiscal policy in Canada has now shifted to what should be done with the prospective fiscal surpluses. As the staff note, economic theory is ambiguous on whether a surplus should be saved or spent. There may be good economic reasons for doing either. In Canada, the arguments do indeed appear to run in both directions.
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> Before turning to those arguments, however, we would underline the staff's suggestion that the size of the "planning surpluses" in the Economic and Fiscal Update are a little misleading. We think it would have been more meaningful to present these five year budget baseline projections on the basis of a full indexation of personal tax allowances.
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> Saving a surplus can enhance confidence in a government's fiscal management, and reduce its vulnerability to adverse shocks. The staff have noted that the level of public debt is relatively high by international standards. However, Canada is clearly not facing a situation where an unsustainable fiscal position is undermining the credibility of macroeconomic management. Real long term interest rates, for example, do not appear to be out of line with those in the United States and Europe.
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> In Canada's case, we think there are two stronger arguments for saving the surplus. First, it would provide some buffer against the future costs of Canada's aging population. Second, it would provide a safe and transparent way of counter-balancing the inevitable political pressures for rapid increases

in public spending on programs which are unlikely to carry significant economic or social returns.

There are, however, also good arguments for spending the surplus. In Canada, these arguments rest most solidly on the need for tax cuts. Marginal tax rates on both personal and corporate incomes are relatively high in Canada. High tax rates have, for example, been cited as one reason why the Canadian IT industry, although performing strongly, has continued to lag behind its U.S. counterpart. The staff have set out some sensible recommendations on priorities for tax reform which we broadly endorse.

There is also a timing issue. Deciding how much of the prospective surpluses should be spent and how much should be saved also depends on the economic circumstances at the time. The authorities' position appears to be that most of the surpluses will be used to increase spending and cut taxes, with only a small portion—the contingency reserve—earmarked for paying down outstanding debt. This suggests that fiscal policy would become more stimulative. Should the U.S. economy weaken substantially this year, then a stimulus could be well timed. However, if the U.S. economy continues to perform strongly then the implied fiscal stimulus risks further stretching the economy and adding to upward pressure on inflation.

On balance, therefore, we agree with the staff that debt reduction and tax reform should be the top priorities in allocating the prospective fiscal surpluses. At this stage of the cycle, we think it would be prudent to favor debt reduction, with the balance switching to tax reforms and a more gradual pace of debt reduction as the economy slows to a more sustainable growth path.

It is hard to argue with the current conduct of Canadian monetary policy. The inflation target has been met continuously in recent years, despite the additional complications presented by pressure on the exchange rate at the end of 1998.

Looking forward, we agree with Governor Thiessen who last week noted that there are two main upside risks to inflation. First, a potential buildup of inflation pressures in the United States that could spillover into Canada. Second, the possibility of a stronger momentum of demand in Canada from both foreign and domestic sources.

We also have one comment on the monetary policy framework. We noted with interest that the monetary conditions index (MCI) has been de-emphasized in the Bank's monetary policy reports, partly because financial market participants have tended to misinterpret movements in the index. This is not surprising. Exchange rate movements, as we all know, are hard to interpret. And without knowing why the exchange rate has moved, it is difficult to determine the appropriate implications for monetary policy of the resulting movement in the MCI.

We welcome the Financial Sector Stability Assessment for Canada and its main conclusions. One of the main themes in the report is the need for regulators to remain vigilant given the increasingly sophisticated and rapidly changing nature of global financial market operations. This challenge is not unique to Canada. But Canada does, arguably, have to deal with an additional complication given the need to ensure the continued smooth operation of regulatory policy across both federal and provincial regulators.

We would also be interested in the staff views on whether the remaining regulatory restrictions on financial sector firms, along with restrictions on foreign participation in the Canadian financial services industry, will slow the process of consolidation and, ultimately, undermine the competitiveness of Canadian financial institutions.

Mr. Shaalan and Mr. Himani submitted the following statement:

Canada's economic performance over the past year has been exceptional by most standards. The fiscal accounts are in a comfortable surplus, the balance of payments is in a solid position, while growth has continued at an impressive pace. Importantly, inflation remained well contained, while the rate of unemployment, still high by historical standards, continued its downward trend. The recovery of the Canadian dollar from the lows reached in 1998 against the U.S. dollar, and small negative interest rate differentials with the United States, are a clear sign of market confidence in the authorities' policies.

This positive outlook notwithstanding, not unlike many industrial countries in a fast-changing global environment, Canada does face potential risks arising in the first instance from the external sector. These risks are amplified by the fact that the Canadian economy has become increasingly integrated with the rest of the world, and in particular the United States. This is true for the real sector, as well as the financial sector, as shown in the accompanying FSSA papers. Furthermore, Canada and the United States are at different stages of their respective business cycles. In the circumstances, Canada is particularly exposed to the risk of a slow-down in the United States. One can draw comfort, however, from the fact that the macroeconomy is well balanced, and is in a relatively comfortable position to withstand an exogenous shock.

These short-term risks aside, the main challenges facing the Canadian authorities are essentially of a medium-term nature. Given the generally favorable economic developments of late, one can think of few circumstances, as propitious as the current environment, for undertaking reforms designed to enhance the long-term efficiency of the economy.

Fiscal policy is the area where the main questions regarding the direction of policies in Canada arise. With the fiscal accounts in surplus, and a generally healthy underlying trend, it is understandable, and entirely expected, that pressures on expenditures will rise. Resisting pressures for expenditures, particularly of an ad hoc nature, will be difficult without relying on a clear, well-articulated medium-term fiscal policy framework. To date, the authorities have pursued a sound and cautious approach, but agreement on a more elaborate medium-term strategy will greatly facilitate the task of fiscal management in the period ahead.

The staff present a number of options, for disposing of surpluses, available to the fiscal authorities at this time—namely, reducing the public debt burden, undertaking cuts in personal or corporate income taxes. These options seem to be all equally desirable, and it is difficult to prioritize among them. However, with growth continuing to be robust, and inflationary pressures well contained, the degree to which slack remains in the economy is not clear. Under such circumstances, an aggressive approach in reducing income taxes may give an undue boost to private demand and, perhaps, inflationary pressures. This does not suggest that reform to the personal and corporate income taxes should not be a high priority. Indeed, the level of these taxes in Canada is higher than that of it competitors, while the structure seems to entail undue distortions, particularly with respect to the service industry. With these considerations in mind, a measured approach in the reduction of the over all level of taxation, while pursuing a more aggressive stance in eliminating distortions in the tax system, would seem to strike the right balance between proceeding with the needed fiscal reforms and avoiding an undue fiscal stimulus at this time. Eliminating distortions owing to the tax system should enhance the productive capacity of the economy, enabling further economic growth without inflationary pressures.

Certainly any move in the direction of tax reform would need to be accompanied by further progress in debt reduction. One can argue that these two policy areas can be competing, from a purely financial viewpoint. However, both policies are mutually reinforcing, with both equally important in laying the ground work for a robust and sustainable fiscal position in the long term. The low level of yields on Canadian government bonds at this time is likely to be a signal of market expectations of further debt reduction, rather than a more relaxed assessment by market participants of the overall level of government debt.

The strong fiscal performance has certainly provided a support for monetary policy. The Bank of Canada’s policy to date has been impressive in many respects, with the authorities maintaining inflation close to the lower end of the target range for some time. This success notwithstanding, the weakness of the Canadian dollar in 1998 underscores the continuing need to err on the side of caution. Looking to the period ahead, it is likely that the Bank will need to match potential hikes in U.S. interest rates, in view of the increasing integration of the two economies, even though it is not clear that this can be justified purely on the basis of domestic inflationary pressures. This is one aspect of globalization that needs to be taken into account in the formulation of the fiscal/monetary policy mix.

Turning to structural reforms, the relatively high level of unemployment during the current favorable economic climate is surprising, and merits particular attention. The reforms in the employment insurance scheme and the provincial social assistance programs appear to have made a significant contribution towards improving the overall efficiency of the labor market. Nevertheless, unemployment in Canada remains above the average of other G-7 economies, and well above that in the United States. Against this background, it is regrettable that pressures to roll back the reforms have emerged. The authorities need to be careful to ensure that new policy initiatives that affect the labor market do not contribute to labor disincentives.

Finally, though Canada’s role in promoting trade liberalization is laudable, there is an issue that the authorities need to address. We find it unfortunate that Canada maintains high levels of protection in Agriculture, textiles and clothing. Early and ambitious liberalization measures in these sectors would be a source of considerable benefit for Canada as well as its trading partners. This is not a problem specific to Canada, it is widespread among industrial countries. During a period of declining aid to developing countries, the case for eliminating barriers to trade assumes added importance for the world economy.

With these remarks, we wish the authorities continuing success.

Mr. Kelkar submitted the following statement:

We commend the Canadian authorities for their sound macroeconomic and structural policies designed, implemented and sustained during the 1990s in a steadfast manner. These policy efforts have been reflected in several outstanding achievements:

- a sharp pick up in real GDP growth over the year to the third quarter of 1999, bouncing back strongly from the adverse effects of the Asian financial crisis and the turmoil in world financial markets in 1998.

- low and stable core inflation rate—around the lower end of the 1–3 percent official target range, coupled with low inflationary expectations underpinned by a high degree of credibility associated with the successful implementation of an inflation targeting framework.

- a drop in the unemployment rate to its lowest level in two decades.

- a substantial improvement in federal and provincial fiscal balances leading to a decline in the ratio of government net debt to GDP, and

- narrowing of the current account deficit with a strong rebound in export growth.

Our chair broadly agrees with the overall thrust of the excellent staff paper. Our comments, accordingly, are focused mainly on the prospective policy challenges faced by the Canadian authorities.

The external environment for the Canadian economy has significantly improved over the last year with the continued buoyancy of the U.S. economy, prospects for stronger growth in Europe and Japan and the strengthening of commodity prices. However, there are many downside risks associated with the continuation of this scenario. The Canadian economy's medium-term outlook could worsen significantly if there is a sharp slowdown in the U.S. economy and/or if economic activity outside North America turns out to be weaker than expected. As detailed in Box 3 (p.14), Canada's prospective economic performance is critically contingent on potential developments in the U.S. economy, and as such, is beset with corresponding uncertainties.

As indicated in the staff paper, there is considerable ambiguity regarding the availability of slack in the economy, as estimates of the output and unemployment gaps range widely. In this regard, the strength of productivity growth in Canada vis-à-vis that in the United States referred to in paragraph 5 (p.4) is not clear. While we welcome the forthcoming selected issues paper on the subject as indicated in footnote 3 (p.4), we wonder whether there is any discussion regarding a "new Canadian economy." The staff comments are welcome.

We fully agree with the staff and the authorities that the near-term aim of monetary policy should be to allow the economy to seek its productive potential without compromising the official target for inflation. It is true that enhanced credibility of monetary policy offers the central bank some additional room to maneuver in testing the economy's productive limits. However, given the ambivalence regarding the extent of slack in the economy, it would be prudent to approach the limits of capacity cautiously. This would help ensure that tighter monetary conditions initiated after reaching capacity output would have a chance to slow demand growth before inflationary pressures could take hold. We also agree with the authorities' view, concurred by the staff, that the key consideration for monetary policy in Canada could be the extent to which continued rapid U.S. growth could add to already strong demand growth in Canada and contribute to a spillover of inflationary pressures.

As to the exchange rate policy, we fully support the position by Mr. Bernes in his helpful preliminary statement that the case for a flexible exchange regime for Canada is not undermined by the high degree of integration with the U.S. economy.

As to the fiscal policy, it may be noted that despite a dramatic turnaround in the federal fiscal position of about 5.5 percent of GDP and some fiscal consolidation at the provincial level, the ratio of general government net debt to GDP still remains well above the corresponding G-7 average (Table 5, p.35). This underscores the need to sustain the medium term focus to bring down the debt-GDP ratio further.

The concept of "planning surpluses" with a built-in contingency reserve and an explicit economic prudence factor is an interesting one. The current and prospective budget surpluses for the Canadian economy, however, are not large as percentage of GDP—0.6 percent in 2000–01 rising to 2 percent in 2004–05. Moreover, as pointed out in the staff report, a significant part of these surpluses emanate from an automatic rise in the real burden of personal income taxes owing to the lack of full indexation to inflation (para 30, p.19). In view of these considerations, it is probably premature to talk about allocating the prospective fiscal surpluses. We however, agree with the staff that debt reduction and reduction of the high burden of personal and corporate income taxes should be accorded a high priority in the emerging fiscal scenario. In this regard, the helpful preliminary statement from Mr. Bernes has made an important point regarding the economic literature being silent on the optimal level as well as speed of convergence toward it in respect of both, government debt and taxes. We agree with Mr. Bernes that the Fund should examine these issues in more detail.

Canada is a strong advocate of open trade and has maintained a highly open trade regime. Not surprisingly, it has the highest trade to GDP ratio among the G-7 countries. However, as noted in the staff report, there are several trade restrictions in agriculture and textiles and clothing. As indicated in footnote 30 (p.26), high levels of protection prevail in respect of textiles and clothing in the form of quantitative restrictions. Moreover, for products not subject of quotas, tariffs remain high, thus impeding the market access to exports from developing countries. Although Canada is technically in full compliance with the Uruguay Round commitments, we would encourage the Canadian authorities to move more quickly to remove these restrictions and reduce tariffs and thus provide a welcome boost to the economies of many developing countries.

We regret to note that Canada's ODA as a share of GNP has declined from 0.46 percent in 1992 to 0.29 percent in 1998. This is unfortunate as well as anachronistic given that the Canadian economy marks its eighth consecutive year of economic expansion. We welcome the Canadian Prime Minister's recent announcement of commitment to moving toward the ODA target of 0.7 percent of GNP, and strongly urge the authorities for an expeditious implementation.

Mr. Harinowo and Mrs. Siti submitted the following statement:

For the Canadians, there is much to cheer about. Among others, its economy is charting further economic expansion with likely growth of about 4 percent in 1999; unemployment is on a declining trend at a low of 6.9 percent from a high of 10.4 percent in 1994; inflation has been kept at bay, which testifies the continued success of the inflation targeting approach to monetary policy; the likely prospects are for even lower public debt/GDP ratio as both the federal and provincial governments adhere to their fiscal management discipline; while structural reforms carried out in the major key areas have yielded positive outcomes. Indeed the authorities are to be congratulated for these achievements.

We are in broad agreement with the staff's appraisal and would also like to thank Mr. Bernes for his concise informative preliminary statement. While we can not seriously envisage our few additional comments here would contribute towards the Canadian economy continued growth, nevertheless, we would like to be party at least to Canada's millennium Article IV consultation discussion.

On the economic front, notwithstanding the gray area on the potential output gap in the economy, we noted that the current source of growth on the domestic front seemed to emanate from the historic high level of capital outlay as well as continued private spending. For the former, we could expect that those investments will add further the potential output in the short or medium run depending on its gestation period. Further, as the staff noted and confirmed by Mr. Bernes, the domestic economy is gathering even further forward momentum at least in the coming six months or so. With its high degree of integration with the U.S. economy, indeed a hard landing on the latter could have serious repercussions on the domestic front including dampening the robust consumption spending. In any event, we are optimistic that the authorities will bide by their commitments to ensure a durable economic expansion as was reiterated by the Bank of Canada's Governor in a recent statement. This also justifies the authorities decision not to compromise on its inflation targeting objectives in allowing the economy to seek its productive potential level, while keeping a close tab of the wide ranging indicators on price and capacity pressures.

On the fiscal front, while we see merit in the staff pushing for faster debt reduction, however, we tend to agree with the authorities more cautious stance in dealing with its prospective fiscal surpluses. The nature of the two-year rolling budget plan will allow the authorities to take up more concrete positive responses if the fiscal outturn is better than expected. In any case, we would also call for the staff to examine the “optimal” public debt path. With regards to the income tax structure, we believe that the authorities are considering speedier steps to address the high burden faced by certain groups of the taxpayers. If we understand it correctly, indeed it is not an enticing thought to be taxed 60 percent for every dollar earned as in the group described in footnote 19. Thus, income tax reform should be aimed particularly in smoothing out the relative burden at different levels of income groups. At the middle-income taxpayers, their tax burden may be eased somewhat as they presently seem to bear the brunt of the current distortion in the tax structure. At the same time, the present low thresholds at which marginal tax rates apply may also be reviewed, apart from those discussed by the staff and the authorities as in paragraph 33. We also encourage the authorities to work towards reviewing its corporate tax rates in comparison with other industrial countries. Needless to say that in all of these exercises coordination between the federal and provincial authorities is paramount.

We commend the Canadian authorities in reducing the level of unemployment. Nonetheless, as the staff noted, the present unemployment rate is still somewhat high compared to the G-7 countries. Therefore, we are pleased to know that the authorities are already taking concrete measures with reforms in the EI system that, to some extent, has reduced the structural unemployment problems that surfaced earlier. We could empathize with the authorities decision to withhold new reforms and have the chance to evaluate the impact of those that were introduced. With regards to the parental leave benefits under the EI, though as the staff noted seem to appear to be a move away from the EI system, we nevertheless see merit in the authorities proposal to its inclusion as elaborated in Mr. Bernes’ statement. Indeed an investment of its human resources at its most opportune time would benefit the nation in the much longer run.

On trade liberalization, the staff noted that there are still some scattered high tariff in selected sectors. I am sure the authorities are aware of this issue and are working towards aligning them to levels most appropriate for Canada. On the ODA, once again we would like to go on record of our appreciation to the authorities for its continued support. With the increased prosperity that the country now enjoys, there is indeed a greater scope for the authorities to increase their generosity in assisting the less fortunate countries.

Finally, we look forward to the lessons to be learned from Canada's experience with the FSSA.

Mr. Morais submitted the following statement:

It is pleasing to reecho the positive sentiments our Chair expressed last year regarding the performance of the Canadian economy. Sound macroeconomic management and structural reforms have remained the bedrock for sustained growth and low inflation. Economic activity has also received an added boost from the propitious external environment in the form of strong demand emanating from the United States and the rebound in commodity prices. Strong growth has contributed to the improved fiscal picture, notably the reduction in the public debt relatively to GDP. However, the economy faces potential risks over the medium term, being highly dependent on changes in the external environment, especially developments in the United States, where there is uncertainty about a possible slowdown in economic activity. On the domestic side, consumer spending could grow faster than expected, as a result of the proposed multi-year personal income tax cuts, posing challenges for monetary policy.

The key policy question raised in the staff report concerns the use of the fiscal surplus. One suggestion by the staff is that the strong fiscal position be used to institute tax reform, given the high burden of personal and corporate income taxes. I agree that efficiency gains from tax reform would be to the long-term benefit of the economy, and steps in this direction should be a priority for the authorities. However, the staff have also noted, in talking about potential risks to the economy on the domestic side, that the proposed multi-year personal income tax cut could lead to consumer spending growing faster than expected, leading to inflationary pressures. In the circumstances, one would advise caution in implementing the tax reduction scheme, given the uncertainty about the degree of slack in the economy.

The other fiscal policy issue that the staff have raised concerns the speed of reducing the public debt, with the staff preferring a more rapid approach. This is a judgment call for the authorities, considering that their fiscal consolidation efforts have already put the debt ratio on a steady downward path. What is needed, perhaps, is a clear medium-term plan which shows the authorities' commitment to keeping debt reduction high on the policy agenda.

On monetary policy, the task is to ensure that the economy remains on a low inflation path. The monetary authorities have already established a good track record in this regard, with their policy of inflation targeting. By dampening expectations of inflation, they have created some room to test the water to permit the economy to reach its potential, minimizing the risk of prematurely putting on the brakes. Meanwhile, we take note of the fact that the authorities continue to be vigilant, closely monitoring various indicators that would help in determining emerging price pressures.

I note that Canada's official development assistance has declined as a share of GNP from 0.46 percent in 1992 to 0.29 percent in 1998. We urge the authorities to reverse this decline, given the improved fiscal situation. In this vein, I welcome the reported intention of the government to increase foreign aid in the next budget, as well as its commitment to move toward a target of 0.7 percent of GNP as the fiscal situation improves. Let me also urge the authorities to take speedy action to remove trade barriers to agriculture, textiles and clothing, areas which could benefit the economies of developing countries.

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

The Canadian economy has continued to perform well over the past year and to bounce back quite nicely from the global financial turmoil and depressed commodity prices that followed in the wake of the Asia crisis. This performance reflects disciplined fiscal policies at the federal and provincial levels, the Bank of Canada's determined anti-inflationary course, greater flexibility of factor markets this decade, as well as stimulus imparted by the strength of the U.S. economy. Canada's experience, along with that of the United States and several European countries, again underscores that high investment and flexible factor markets, including labor, can alter the traditional relationships between growth and inflation in ways that produce tangible benefits for economic vitality.

Canada's monetary policy management has been commendable, especially given the buffeting from global crosscurrents. This owes much to the Bank of Canada's adroitness, which is being reinforced in the marketplace by the credibility the Bank has gained throughout the decade. Box 2, noting the high degree of integration between the United States and Canada, raises the question of the optimal monetary regime for Canada which has been extensively debated in Canada. Given the central bank's skillful management and the asymmetry in the shocks that could hit the two economies, Canada's desire to pursue inflation targeting strikes us as justified and reasonable.

We welcome the monetary authorities' willingness to allow the economy to seek its productive potential. Notwithstanding robust growth and declining unemployment, productivity gains as well as some slack in labor markets have kept Canadian unit labor costs in check. Meanwhile, higher energy prices have boosted overall inflation, but with little apparent spillover effects into underlying wage pressures and demands. Indeed, core inflation remains below the mid-point of the inflation target range, inflation expectations are low and monetary conditions have tightened since the end of 1998. These factors underscore the wide range of uncertainty associated with estimating productive potential and output and employment gaps.

It goes without saying that interpreting such factors makes the lives of central bankers difficult and that Canada will need to continue its prudent management of policies. The questions that will undoubtedly confront monetary authorities in the period ahead are whether inflation might pick up given that slack has diminished and to what extent the strong growth of recent years is more than just a cyclical phenomenon. More generally, some of the similarities between the Canadian and U.S. experience in recent years might suggest that an instinctive tapping of the brakes on a recovering economy would do more to nip good growth and higher incomes in the bud than dampening price pressures.

Canada's resolute fiscal consolidation this decade has facilitated the decline in interest rates and inflation and helped lay the foundation for sustained growth. Moreover, Canada has taken critical steps to put its pension program on a sounder long-term footing while freeing up automatic stabilizers so as to minimize the possibility of pro-cyclical tightening in the event of a downturn. The authorities now face the difficult but enviable decisions about what to do with existing and prospective surpluses.

The staff and the authorities are broadly in agreement on a number of key issues, including the soundness of the current fiscal position and the goal of ensuring prudent budgets going forward, the need to reform the personal income tax system to reduce high marginal tax rates and the objective of making the corporate income tax system more competitive. Both the staff and the authorities are interested in Canada paying down its national debt. The staff emphasizes a more rapid paydown of the debt, however, while the authorities take a more nuanced position given the political realities of dealing with spending pressures. This debate is not unfamiliar to us, and our chair has a basic appreciation for both points of views. Paying down the national debt would undoubtedly benefit overall economic performance, and Canadian governmental spending as a share of GDP is quite high. But at the same time Canada's current ratio of debt to GDP and prospective trends by no means raise fundamental sustainability issues. What is critical is that the authorities continue their successful management of fiscal policy.

As noted above, increased flexibility of factor markets has been instrumental in supporting Canada's strong performance in recent years. In this light, the reforms to date in the EI system have proven especially critical for lowering structural unemployment and sustaining the expansion. Hence, we support the authorities' effort to resist rolling back the reforms to the EI system and we agree that unemployment assistance should primarily be viewed as a form of insurance. The authorities have also made progress in addressing poverty traps. Nevertheless, structural unemployment remains high and there is further room for factor market reforms to sustain growth.

Canada's Financial System Stability Assessment (FSSA) underscores the strength and robustness of the financial system. It was a first-rate piece of work.

Turning to the financial services sector in Canada, let us make two brief observations. First, the United States was pleased that Canada enacted legislation in June 1999 permitting foreign branch banking in Canada. This should open the door to increased competition in Canadian markets by U.S. and other foreign banks, which have been limited until now in that they could operate only through separate subsidiaries in Canada. However, some seven months have elapsed since the legislation was enacted, and a related tax bill and regulations implementing the new foreign branch bank law still remain to be approved and put in place. These delays are forcing foreign banks to postpone their own business decisions on switching to a branch or opening a branch until full implications of such decisions become known.

Secondly, Canada has been engaged for some time in a process of study and debate about how best to reform Canada's financial services sector. The central principles of Canada's reform effort, which the United States fully supports, include greater growth and efficiency, more domestic competition, consumer protection and an improved regulatory environment. Last June, the Canadian government released a policy paper on these issues and said it would be introducing legislation to implement the new financial services sector policy framework later in the year. Although that legislation has been delayed, we look forward to reviewing it as soon as it becomes available.

Finally, given the high degree of integration between Canada and the United States and the much larger size of the U.S. economy, the staff quite understandably focused at length in the staff report on the forces emanating from the United States affecting the Canadian economy. As has seemingly become ritual in the Fund in recent years, this discussion—as noted in Box 3—highlighted the risks of a significant increase in interest rates if U.S. inflation surges and the consequences of a sharp U.S. equity price correction. These are valid risks to discuss, and they are not new to the Board.

But the Canadian and U.S. performance of recent years highlights some other experiences that are not fully explored that could have potentially important ramifications for the Fund's conduct of multilateral surveillance and the world economic outlook. To cite a few that pertain to both countries to varying degrees, both have been in a virtuous circle and grown rapidly for a sustained period without an apparent kindling of price pressures and with implications for the conduct of monetary policy; both have achieved productivity gains despite a maturing cycle; and both have witnessed increases in equity prices and declines in private savings in the context of rising national savings. For example, page 10 (footnote 10) of the Canadian report highlights that fiscal consolidation, reduced inflation expectations, and rising household net worth explain Canada's decline in trend personal savings, just as Box 2 of the U.S. Article IV noted that these same factors—in broadly similar magnitudes at that—explained the decline in the U.S. personal savings rates. We would have found most useful a fuller discussion of these similarities. Indeed, an examination of these broadly similar experiences might be a useful focus for the staff's future conduct of multilateral surveillance, both in terms of proffering lessons for the management of economic policy and for seeking ways to create a more balanced pattern of global growth.

Mr. Mirakhor submitted the following statement:

We thank the staff for an excellent report. Canada's economy continues to perform admirably, marking its eighth consecutive year of expansion, with virtually no evident trouble spots or vulnerabilities. Economic growth has been brisk, inflation has remained at low levels, thanks to the success of the Bank of Canada's inflation targeting framework, and there has been a sharp improvement in the federal and provincial fiscal balances and an associated fall in the ratio of government debt to GDP. Important structural reforms have been implemented, most notably in the labor market, resulting in a drop in unemployment to its lowest level since 1976. We join the staff in commending and congratulating the Canadian authorities for their accomplishments.

As Mr. Bernes notes in his statement, despite the authorities' success in managing their economy, the task ahead remains challenging. In the fiscal area, the prospect of surpluses raises the issue of whether and how best to use them. While the staff and the authorities agree that debt reduction and income tax reform promise the highest rewards in terms of economic efficiency, there are differences in the emphasis pertaining to each goal. Although the literature provides limited guidance on what the optimal path for debt reduction should be—and we join Mr. Bernes in encouraging the staff to examine the issue in more detail—we believe there is merit in the staff's preference for a somewhat quicker pace of debt reduction, especially given the presently favorable economic conditions, with tax reforms being phased in at a subsequent stage. Such an approach would serve to bolster the credibility of the authorities' overall macroeconomic strategy, reduce the burden on monetary policy, and create the fiscal space necessary to address the looming fiscal costs of an aging population.

The conduct of monetary policy in Canada has been exemplary. With credibility firmly established and fiscal policy on a solid footing, the Bank of Canada has flexibility and room to use monetary policy to deliver low inflation and test the economy's productive limits. However, given the inherent difficulty in judging how much slack actually exists and the rapid pace at which the economy has been growing, this will be a challenging task. It will be important to know at which point the policy will need to shift towards restraint so as to slow the momentum of demand before hitting capacity constraints. We welcome Mr. Bernes's assurance that the Bank of Canada will respond promptly and firmly if signs of pressure on capacity or inflation should emerge, and the Bank's close monitoring of a wide range of indicators should help in that assessment. The authorities would need to be especially vigilant against undesirable spillover effects of inflationary developments emanating from Canada's main trading partners.

In the structural area, the reforms of the employment insurance system have clearly had a salutary effect on the unemployment rate, which is welcome. Nevertheless, as the staff note, Canada's unemployment rate remains high both in a historical context and in relation to its trading partners suggesting that disincentives to employment remain. We note the recent build-up of pressures to roll back some of the reforms as they become binding and welcome the authorities' commitment to resist these pressures. While Mr. Bernes presents an eloquent case for the recently enhanced EI parental leave benefits, and we share his sentiments, it is important to ensure that this proposal—while eminently worthy in its own right—does not heighten pressures for additional benefits elsewhere in the system. In the trade area, Canada's advocacy and commitment to an open trade system is widely recognized and appreciated. Given this background, it would be befitting if the authorities took the lead in reducing tariffs at an early stage in those areas of interest to developing countries.

We commend the quality and breadth of the FSSA review which, inter alia, confirms the fundamental soundness of the Canadian financial system and regulatory framework. Nevertheless, the staff note that the combination of global competitive pressures and the changing nature of financial instruments will pose challenges for the system in the period ahead, underscoring the need for developing and maintaining robust risk management tools.

Finally, we welcome the recent statement by the Prime Minister that Canada intends to increase the level of foreign aid in the next budget.

Mr. Portugal and Mr. Junguito submitted the following statement:

We would like to thank the staff for an excellent Article IV report and for the interesting Selected Issues paper and the Financial System Stability Assessment. We also thank Mr. Bernes for his informative statement.

For eight years now Canada has maintained an impressive record of non-inflationary economic expansion. Last year the economy rapidly bounced back from the slowdown caused by the turmoil in world financial markets.

Unemployment continued to decline and was reduced to the lowest level in two decades. The external position has improved comfortably, helped the recovery of commodity prices and the positive incidence of U.S. growth. This outstanding performance should be credited mainly to the sound framework of macroeconomic policies and the structural reforms that the authorities have been consistently implementing. The sharp fiscal consolidation at all levels of government during the past five years has put the debt-to-GDP ratio on a steady downward course. A skilful implementation of monetary policy under an inflation-targeting framework kept core inflation within a narrow range around 1 to 3 percent, while inflationary expectations remained centered around the 2 percent mid-point of the official target band. This performance has enhanced the policy credibility of the Bank of Canada. Important structural reforms in the employment insurance scheme and in the provincial social assistance programs contributed to reduce structural unemployment and to strengthen the incentive to work, while further progress was made in reducing barriers to inter-provincial trade. We wish to commend the Canadian authorities for these policies and results.

Canada’s success in lowering its fiscal deficit was based both on a dramatic turnaround in the central government deficit, which shifted from a deficit of more than 5 percent of GDP in 1993/94 to a surplus in 1998/99, and on fiscal consolidation at the provincial level. A deeper understanding of the institutional aspects of fiscal coordination between the central government and the provinces would be helpful to other countries such as Brazil and Colombia, where the management of sub-national fiscal issues is both important and complex.

The authorities are now in the enviable position of having to decide how to best use fiscal surpluses which are projected to grow to up to 2 percent of GDP by 2004/5. We agree with the authorities and the staff that using the surpluses to reduce personal and corporate income tax is likely to produce substantial gains in terms of economic efficiency and competitive position. As shown in the Selected Issues paper, the ratio of personal income tax to GDP is relatively high, reflecting the progressively steep taxation of income. On the other hand, the combined federal and provincial statutory rate for general business income is high compared to those of other NAFTA members, as well as of the United Kingdom, which are Canada’s main trading partners. Coordination with the provinces in this endeavor is essential to avoid them taking actions that would offset the federal measures. Also, the costs of the tax reform should not risk the fiscal consolidation already achieved.

We also agree on the desirability of further diminishing distortions of business taxation by implementing the measures recommended in the government report on the subject, such as reducing the research and development tax incentives that are among the most generous in the world.

Using the budget surpluses to further reduce public debt is also likely to produce significant long-term benefits, as Canada's debt-to-GDP ratio is larger than the G-7 average. The staff suggests a somewhat faster pace for debt reduction than what is envisaged by the authorities. Here, however, we agree with the authorities' plan of targeting an ex-ante balanced budget and using the ex-post unspent contingency reserve for debt reduction purposes. The difference in the debt ratios between the two approaches is just 1.5 percentage points of GDP and there is no firm theoretical guidance with respect to the optimal level and path of public debt.

In spite of the uncertainty over how much slack still remains in the economy, we share the authorities' view that monetary policy should allow the economy to continue to expand, prudently and at a slower pace, in order to test its limits of non-inflationary growth. This view is warranted not only given the difficulties that usually beset the measurement of output gap, but also because the Canadian economy has benefited from substantial investment and from the introduction of new technologies that may have raised its productive potential beyond what could be captured by existing models.

Developments in the U.S. economy have a significant impact in Canada given the high degree of economic integration between both countries and, therefore, should be carefully monitored. However, we agree with the authorities that there should not be an automatic rule on how to respond to increases in U.S. interest rates and that monetary policy should focus on Canada's underlying economic fundamentals. As Mr. Bernes points out in his statement, Canada has experienced asymmetric shocks with respect to the U.S. economy that typically require real exchange-rate adjustment allowed by a flexible exchange-rate regime. The credibility gained by the inflation target framework helps to cushion eventual external price pressures. Monetary policy should respond promptly if there are signs of significant spillover of inflationary pressures resulting from such external developments.

On the structural front, further improving labor market flexibility continues to be required as structural unemployment in Canada is still higher than in the United States and seems to be partially linked to the more generous employment insurance scheme. Hence, we agree with the staff that it is important for the authorities not only to resist pressures to roll back the recent reforms in the employment insurance scheme, but to take additional steps to reduce remaining disincentives to work.

We also join the staff in encouraging the authorities to move ahead on trade liberalization in agriculture where out-of-quota tariff rates are extremely high, and in textiles and clothing where both quantitative restrictions and high tariffs persist.

As the Financial System Stability Assessment points out, Canada's financial system is sound and stable. It is also noteworthy that international standards and codes have been observed to a high degree of compliance. We share the view expressed by the staff on the importance of coordinating and harmonizing regulation and supervision at all levels of government, especially in regard to securities regulation where provincial governments have considerable authority.

Mr. Barro Chambrier and Mr. Thiam submitted the following statement:

We commend the Canadian authorities for the continued good performance of their economy which is in the eight consecutive year of expansion. This performance is a reflection of the success of the sound macroeconomic and structural policies implemented over the past years, and have also helped the country to withstand the adverse exogenous shocks from both the Asian crisis and the recent turbulence in the financial markets. We also welcome the sharp improvement in the federal and provincial fiscal balances as well as the decline in the ratio of government debt to GDP ratio. The significant decline in the unemployment rate and the low inflation rate are also positive developments. Overall, the policies being implemented by the Canadian authorities have been appropriate and conducive to growth.

From the staff report, and Mr. Bernes' helpful statement the areas of concerns appear to be, among others, the degree of slack in the economy, the relatively high level of public debt to GDP, and the high rate of taxation.

On the degree of slack in the economy, this could be an area of concern if the economy is nearing full capacity. But on this issue, we note that the staff agree that there are uncertainties as regards estimates of output and employment gaps. As indicated in Mr. Bernes' statement this is particularly true after a period of business restructuring, rapid technology changes, and the new and recent investments. In this context we welcome actions undertaken by the Central Bank of Canada to monitor indicators of capacity. Moreover, even growing at a more robust pace and with significant decline in unemployment, inflationary pressure does not seem to be presently a problem in Canada. We would, therefore, not be inclined for a tightening of policies. On the contrary, we are of the view that present macroeconomic policies are on the right track, and that the authorities should take opportunity of the present positive trend to address other structural issues, especially in the labor market. While we welcome the recent decline in the unemployment rate to below 7 percent, we are also of the view that this level of unemployment is still high, and that efforts to improve the efficiency of the labor market should be continued, so as to create more employment opportunities.

Given the high integration of the Canadian economy with that of the United States, we note the concerns of the staff regarding the spillover of inflationary pressures as the U.S. economy approaches full capacity. While, we would agree that the Canadian authorities should monitor developments closely, it is clear that they have some leeway in responding to external developments, and we would recommend following a steady course for the near term.

In the fiscal area, the authorities, since 1994, have established an impressive record of fiscal consolidation, both at the federal and the provincial levels of government. However, the level of public debt, although on a declining trend remains high, and we agree with the staff that the authorities should continue their efforts to bring down the ratio of government debt to GDP. While we welcome the envisaged fiscal surpluses over the medium term, which should help to reduce the level of debt, we note that they rely much on automatic rises in the personal income tax. Moreover, as pointed out by the staff the level of personal and corporate income taxes, remain high and there is a need to lower them. We agree that the authorities should undertake a comprehensive reform in those areas including as indicated in Mr. Bernes' statement the reduction of taxes to secure gains in economic efficiency. The Technical Committee has made a number of important recommendations with regard to the corporate tax and if implemented they could help to reduce the many existing disincentives. More broadly, a review of the policy mix could also help with more efforts aimed at reducing expenditure, so that both objectives of lower taxes and lower debt to GDP ration can be achieved.

In the monetary area, the authorities' approach have been successful in containing inflation at a low rate, and also at increasing the credibility of monetary policy, thus giving the authorities more room to maneuver. However, in view of the integration of the Canadian economy with that of the U.S. and the dependence of Canada's exports on primary commodities, exchange rate developments need to be carefully monitored, and policies should not lead to the undermining of confidence in the Canadian dollar.

On trade liberalization, we are encouraged by the authorities' strong commitment to maintain an open and free trade system. However, we note that there are still high rates of protection, especially as regards agriculture, textiles and clothing. We encourage the authorities to accelerate their liberalization efforts in these areas, which can enhance the Canadian economy's efficiency.

Finally, on ODA, while we commend the Canadian authorities for their continued assistance to developing countries, we note that the level of assistance has declined over the years. We encourage the authorities to continue their efforts to increase their ODA to meet the target of 0.7 percent of GNP.

Mr. Kiekens made the following statement:

Canada is enjoying the rewards of stability-oriented macroeconomic policies and market-oriented structural reforms: strong growth, low inflation, solid broad-based job creation, a small current account deficit, the general government budget in comfortable surplus, and net public debt steadily shrinking. This enviable situation reflects, inter alia, remarkable fiscal efforts, especially on the expenditure side, at the federal and provincial levels of government over the last six years. The good results of Canada's good policies, abetted by vigorous economic activity in the United States, have resulted in the current strong and job-rich expansion.

In Canada as in the United States, the monetary authorities have had to make delicate decisions about when and how much to raise short-term interest rates to keep inflation low while avoiding an interruption of the ongoing expansion. Making the right decisions in monetary policy requires reliable estimates of a country's potential real growth rate. I was surprised by the consensus between the staff and the authorities that Canada's potential real growth rate lies between 2.25 and 2.5 percent per year. Last summer, the staff revised its estimate of U.S. potential growth from 2.25 to 2.75 percent per year, based on durable productivity improvements achieved by the use of new information technologies, cost-cutting management practices, and other efforts by firms to increase efficiency in response to labor shortages and sharper competition. I wonder whether similar factors may not be at work in Canada, and if so whether they do not justify an upward revision of the rate of potential growth. What does the staff think about this?

All indicators bolster the credibility of the Bank of Canada's monetary policy: inflationary expectations are near the middle of the target range; wage growth is well aligned with productivity increases; and long-term interest rates are slightly lower than in the United States. I note that the Bank of Canada intends to use a broader range of inflation indicators, including monetary and credit aggregates, in setting monetary policy. This pragmatism strengthens my belief that, whether they belong to the inflation targeting or the monetary targeting camp, monetary authorities share a great deal of common ground in the daily practice of central banking.

Given the overall excellence of their macroeconomic track record, it is not surprising that the Financial Sector Assessment papers praise the authorities' success in preserving financial sector stability and dealing transparently with the financial markets. In Canada's sophisticated financial market, fully integrated into the global financial system, supervisors are constantly challenged to keep up with innovations and market developments. Therefore, like Mr. Pickford and Mr. Burgess, I wonder what is the rationale for the remaining restrictions on foreign participation in Canada's financial sector, and their effect on the competitiveness of Canadian financial institutions.

When assessing the soundness of the U.S. financial system last year, it was noted that commercial banks' business loan portfolios were deteriorating slightly in consequence of a growing trend on the part of top-rated corporations to place their commercial papers directly in the financial markets. Is it likely that the perceived soundness of Canada's banking system will be affected by a similar deterioration in the business loan portfolios of commercial banks when the economy slows down? And how confident is the staff that off-balance sheet operations are soundly managed in the Canadian financial system, as such management is another major risk factor in today's highly sophisticated financial markets?

Thanks to the remarkable success of fiscal consolidation at the federal and provincial levels of government, the authorities are now able to ponder what they should do with substantial budget surpluses now and in coming years.

For myself, I see little advantage in the slightly faster reduction of public debt urged by the staff. Indeed, it is the continuity of the downward trend, rather than the level of debt at any given moment, that is important for preserving market confidence. But even so, I altogether agree with the staff's suggestion that any windfall coming from economic conditions that are more favorable than assumed in the budget, should be used to speed the reduction of debt. Following this simple rule will avert the usual result of windfalls, which is a weakening of the public finances.

Tax cuts spring immediately to mind as an appropriate use of future budget surpluses, given Canada's relatively high tax burden. The staff provides useful suggestions for reducing personal and corporate income taxes. In addition, I would like to suggest targeted fiscal cuts that would reduce the non-wage costs of non-skilled labor. Indeed, even after reforming the unemployment insurance and social assistance systems in order to increase incentives to work, Canadian unemployment remains stubbornly high compared to the United States. This indicates that the cost of low skilled labor is still too high compared to its productivity, or that the unemployed do not have the right skills to get a job. Obviously, under these circumstances, strong incentives to work will not suffice. Non-wage costs of low skilled labor should be reduced, as I suggested earlier, and the long-term unemployed who lack the skills needed to find a job should receive appropriate training.

Finally, I was pleased that during an the Article IV consultation with an industrial country like Canada, the staff gave appropriate attention to trade liberalization efforts vis-à-vis the poorest developing countries. Industrial countries have recently embarked on an elaborate effort to relieve the external debt of Heavily Indebted Poor Countries. To be meaningful, such debt relief has to be complemented by easier market access for HIPC Initiative exports to industrial country markets, and that will require more trade liberalization.

Mr. Toyama made the following statement:

I appreciate the staff's concise and well-crafted paper. I commend Canada for its remarkable economic performance, as is reflected in its high growth, low inflation rate, and decreasing unemployment rate. These macroeconomic indicators show that the economic policy conducted by the Canadian authorities has been truly successful. One important reason for this, however, is that the United States is Canada's largest trading partner, and the booming U.S. economy has sustained exports. As long as the U.S. economy thrives, the Canadian economy will continue to grow. This situation will not last, however. Rather than depend on the future course of U.S. policy, Canada should focus on how to minimize its negative effects in the future.

I applaud the improvement in fiscal balances that has allowed room for flexible fiscal policy management against external downside risks. If such risks do not materialize, it would be appropriate to introduce fiscal reforms that could be more painful in less favorable circumstances. In particular, implementing income tax reforms would have a positive supply side effect, by strengthening work incentives and eliminating market distortion. I would encourage the authorities in that direction. Such reforms should attract public support.

While the authorities should accomplish as much as possible on the fiscal side to realize long-term returns, careful monitoring of the markets will be required on the monetary side. Although improvements in labor market flexibility as well as EI reform have increased labor market capacity, a decline in the unemployment rate includes the potential for a wage boost.

Bearing in mind that the depreciation of the Canadian dollar could impose inflation pressures, there is room for the authorities to maneuver should the United States raise its interest rate or should its booming economy begin to diminish.

Mr. Wei made the following statement:

At the outset, I would like to thank the staff for their excellent report and Mr. Bernes for his comprehensive and informative preliminary statement. The strong rebound of economic activity, low inflation, the notable increase in national savings, remarkable achievements in fiscal consolidation, and record low unemployment are clear proof that the Canadian economy has been running on a dynamic and sound path. I would like to join other speakers in commending the authorities for their skillful macroeconomic management and their considerable accomplishments. Despite these achievements, the authorities are fully aware of the new challenges ahead and are prepared to address them in an orderly manner. As I broadly agree with the thrust of the staff appraisal, I shall just comment on a few areas.

On fiscal policy, the continued efforts in fiscal consolidation have turned the chronic deficit around and resulted in the second consecutive annual budgetary surplus in 1998–99. The Canadian authorities deserve our commendation. The focus has been shifted to how to use the emerging surplus. In light of the comparatively high debt-to-GDP ratio and personal income tax rate, I concur with the staff that the Canadian government should take advantage of the favorable economic climate and strong fiscal position to make the issues of debt reduction and income tax reforms its top priority. I also note that the authorities intend to target a balanced budget on an ex ante basis and to use any unspent portion of the contingency reserve to pay down debt. Along with this approach, the authorities expect to bring the debt ratio under 50 percent. Probably, this option is not as ambitious as that proposed by the staff. However, I do see merits in such a "conservative" approach which may provide the authorities with more room to manage the balanced budget and encounter unanticipated situations.

In addition, Mr. Bernes, in his preliminary statement, raises an interesting question about the rhythm of debt reduction and the appropriate debt ratio level. It is believed that such issue has a wider dimension than Canada itself. I echo the call by Mr. Bernes to examine this issue in more detail.

On monetary policy, the successful implementation of monetary targeting has served Canada quite well. The high creditability of such a mechanism has facilitated lower long-term interest rates and inflation expectations. At the current juncture, both the staff and the authorities have recognized that, given the considerable uncertainties regarding estimates of output and employment gaps as well as the implications of business restructuring, technological advances and large investment in capital goods, it is difficult to measure the production potential cutoff line. Under such constraints, to test the economy's productive capacity requires considerable caution in the setting of monetary policy. I endorse the staff's recommendation that the near-term monetary policy is to ensure that the limits of potential output are not approached with undue speed to minimize the risk of hitting capacity constraints before the policy has sufficient time to contain the excess demand pressures. Meanwhile, inflation developments in Canada's major trading partners will also be an important reference in setting monetary policy owing to Canada's high degree of openness and the large contribution external trade makes to output and demand.

On the structural front, I welcome the progress in reforming employment insurance, the pension plan, and the social assistance program introduced by the federal and local authorities during the past few years. Despite the robust rebound of economic activity, the still comparatively high unemployment rate has marked the need for further reform of the social safety net and relevant mechanisms. It is noted that the authorities intend to carry out a full assessment of the impact of the reforms already in place before moving to the next step, which, we believe, is rational. We also agree that the phasing of further reforms in these areas will facilitate advance gains in economic efficiency and productivity in the medium term. Meanwhile, the current favorable economic environment can make these kinds of reforms less painful. I encourage the authorities to carefully weigh the pros and cons.

On the external sector, while I appreciate Canada's firm commitment to trade liberalization and the authorities' efforts to reduce trade barriers through various channels, I also share the concerns of Mr. Shaalan and others over high protection in the agriculture, textile, and clothing sectors. We believe that opening in these sectors will be beneficial to the developing countries.

Last but not least, it is of serious concern to note that Canada's ODA as a share of GNP has continued to remain low, especially at a time when private capital flows to developing counties have shrunk. In this regard, I join the staff in welcoming the government's intention to increase foreign aid in the next budget, and encourage the authorities to augment ODA in a front-loaded manner and move toward the UN 0.7 percent target as soon as possible.

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

Mr. Couillault made the following statement:

The Canadian economic performances make it difficult to find some fields where progress could be made. I am therefore tempted to encourage the authorities to continue in that direction and stop my statement here. Nevertheless, I would not like to give the impression that I have an easy job to do and that I do not read the excellent papers the staff has provided to us.

So, I will make a few remarks on fiscal and monetary policy.

Over the past six years the federal fiscal position has dramatically improved and now raises the issue of the use of expected surpluses. Mr. Bernes recalls that the government is committed to reducing taxes in the coming years. In good times comes naturally the difficult question of tax reform.

Even if it is commonly said that, like wine, a good tax is an old tax, even wine should be decanted from time to time.

The staff rightly points out that the absence of full indexation of the personal income tax may have detrimental effects on middle-income tax payers. The staff argues that full indexation reduces uncertainty and facilitates better and longer-term planning while limiting the authorities room for maneuver.

As the United Kingdom and Sweden have taken different stances on this issue, I was wondering if the question of indexation has been analyzed in the context of the credibility of an inflation targeting framework.

The Canadian authorities have to be commended for their skillful management of monetary policy. Indeed, despite the recent increase in oil prices, inflation in Canada remains under control and it is interesting to note that interest differentials with the United states turned to be negative in 1999. Against this background, the positive results of this first FSAP in an industrialized country are not surprising.

I nevertheless must say that I am a bit disappointed: given the amount of knowledge and expertise invested in this mission, and given the fact that no FSAP will be organized in Canada for years, I would have expected to find the main vulnerabilities of the financial system more clearly exposed in the article IV report. This is indeed a difficult task as we probably have to dig further in the issue of what is a vulnerability. If we want the FSAP initiative have a major role in our surveillance process we have to extract all the value added of such a mission.

In this context I want also state that we have to clearly differentiate this work from the selected issues paper provided to us. The FSAP should not be just an other document. As we face resources constraints there is probably room for improvement in the coordination process and maybe the staff could try to focus the selected issues to topics related to the financial sector in order to have a full picture.

Certainly, the relatively small place devoted to the FSAP conclusions in the article IV report is largely owing to the quality of the supervision. I would also like to state that my remarks are in no way a criticism of the excellent job that has been done in the selected issues. But as we are still in an ongoing process, I believe that we should take every opportunity to define our expectations. Maybe the staff, or Mr. Bernes, wish to comment on this issue.

Mr. Al-Turki made the following statement:

The Canadian economy has performed admirably over the past 12 months on all three of the usual criteria of growth, employment, and inflation. Growth remained robust; unemployment declined; and core inflation stayed in check. With such a record, the challenge is to ensure that this exemplary performance of the economy is sustained.

The Bank of Canada should be highly commended for its handling of monetary policy over the past few years. The demands on monetary policy will increase, however, as the economy moves closer to its potential. Monetary management is further complicated by the limitations of economic forecasting, particularly with regard to the time lags between policy actions and the economy's response. There are also substantial difficulties in pinpointing capacity constraints especially in an economy undergoing rapid technological changes and large productivity gains. In this connection, the Bank of Canada's close monitoring of a wide range of indicators and its willingness to respond promptly to changing circumstances are reassuring.

That said, let me stress that so far the indicators of capacity slack, core inflation, and productivity growth do not seem to signal a need for change in the current stance of monetary policy. However, this situation could change if increases in U.S. interest rates put pressure on the Canadian dollar and threaten the inflation target. Thus, continued cautious policies are necessary to maintain the delicate balance between economic growth and inflation containment.

Monetary policy success has been greatly facilitated by the impressive gains in fiscal consolidation. Fiscal surpluses offer a major opportunity to reduce the debt-to-GDP ratio, which remains relatively high. Furthermore, the strengthened fiscal position will permit a carefully phased reduction of the high tax burden, thus adding to the economy's efficiency and growth potential. In this context, I consider reducing the high corporate tax rate a priority. Here, Mr. Bernes' statement that the authorities are committed to taking action on these issues is reassuring.

I welcome the progress made in reducing unemployment over the past few years. This progress reflected good growth performance as well as increased labor flexibility. There is still room, however, to further strengthen the employment picture. In this connection, I see merit in the suggested experience-rating in setting unemployment insurance premiums. A move to narrow inter-provincial differences in unemployment benefits is also important.

In the financial sector, the conclusion of the FSSA that Canada's financial system is one of the soundest in the world is good news. The authorities' ongoing efforts to address new challenges from rapidly changing financial markets and the growing integration with the U.S. markets are encouraging. In this context, I endorse the ongoing efforts to reduce regulatory complexities by enhancing coordination between provincial and federal regulators and supervisors.

Finally, I welcome Canada's commitment to further trade liberalization as evidenced by the substantial progress made in reducing trade barriers. However, as the staff and other Directors rightly note, reducing the high protection rates in agriculture, textiles, and clothing would benefit both Canada and many other developing countries. I also join the staff in welcoming the authorities' intention to increase ODA in the next budget.

With these remarks, I wish the authorities further success.

Mr. Palei made the following statement:

I commend the staff for a concise and informative overview paper and a set of five short papers highlighting the key challenges for economic policymakers in Canada. Given the mighty recovery in Asia accompanied by a rise in commodity prices and taking into account continuing strong performance of the United States, it is not surprising that Canadian economy is also doing rather well. I will add a few comments on some of the issues selected by the staff for the Article IV Consultations. In my statement I would like to emphasize the growing interdependence between Canada and the United States in international trade, capital and labor mobility. It seems to me that the power of the relationship between the two countries justifies the staff's frequent comparisons of two countries and the use of the key features of the U.S. economy as a guide to the changes in Canada.

I agree with Mr. Bernes that inflation targeting and flexible exchange rate contributed to smooth adjustment when Canada had to face negative changes in terms of trade and turbulence in the international financial markets. I would also agree that, owing to the lag in the Canadian business cycle as compared to that of the United States, current arrangements are likely to soften a shock from possible abrupt slowdown in the United States. Under the existing circumstances, the flexible exchange rate regime combined with inflation targeting is a factor decreasing Canadian vulnerability to external risks. However, we should not forget that, firstly, in 1998 and 1999, owing to prior fiscal consolidation and visible decline in the public debt-to-GDP ratio Canada was less vulnerable to the financial pressures. Secondly, contemporaneous decline in commodity prices and an unusually strong growth in the United States is a fortunate for Canada coincidence which may or may not be there in the future. Hence, successful turnaround in the Canadian economy should not be attributed primarily to the monetary regime. In making inferences about the appropriateness of flexible exchange rate regime in the future, it is essential to look, in addition to the historical data, at some of the powerful economic trends currently changing the structure of the Canadian economy. For example, it would be reasonable to place more emphasis, as the staff do, to the evidence that, in addition to trade links, growing capital mobility and integration of the financial markets in Canada and the United States impose serious constraints on the monetary policy in Canada. As the economy of Canada is much smaller than that of the United States, one may argue that the Canadian monetary policy is facing diminishing ability to absorb shocks and, instead, will become more and more dependent on economic and monetary conditions in the United States.

While I accept the notion of greater asymmetry in the nature of shocks to the Canadian and U.S. economies, their importance for the choice of the exchange rate regime, an issue specifically mentioned by Mr. Bernes in his preliminary statement, may fade with rapidly deepening integration of two economies. When comparing costs and benefits of alternative regimes, such as the use of a single currency, Canadian authorities may be forced to pay more and more attention to the considerations of competitiveness of the Canadian businesses and to additional burden placed on them by the presence of currency risks. Common currency may eventually be recognized as a better alternative for more dynamic diversification of the Canadian economy and for limiting its current vulnerability to commodity prices.

Similarly to the monetary policy, integration with the United States affects other features of the Canadian economy. It is already pushing the Canadian authorities toward harmonization of the structure of the direct taxes, including their effective rates. Harmonization of major features of taxation in the United States and Canada is probably both desirable and inevitable. It would strengthen competitive position of the Canadian businesses, and might have a priority in fiscal policy in Canada and it warrants the use of additional fiscal resources.

As for the public debt level, it seems to me that, in Canada, there is an additional reason to lower it faster. As integration with the United States deepens and monetary policy becomes less potent, the authorities should pay special attention to the work of automatic stabilizers. Low public debt, in my view, would greatly facilitate their work and allow for larger gyrations in fiscal accounts over the business cycle without damage to the authorities' credibility. Faster debt reduction could give the authorities more freedom in using fiscal policy for macroeconomic management. Overall, as far as the immediate options for the use of fiscal surplus in Canada are concerned, I lean toward the staff's opinion that it would be prudent for the authorities to take a more conservative stance here.

However, I would not insist on the formulation of a rigid and well-defined medium term fiscal strategy for Canada, and, instead, would prefer the more cautious approach advocated by Mr. Bernes. As mentioned above, the uncertainty about the pressures on the fiscal system in Canada caused by the rapid integration with the economy of the United States, in my view, is high. If faster structural changes in the Canadian tax system will be called for, the authorities' step-by-step approach to the use of the envisaged fiscal dividend could be more appropriate. At this stage, the authorities are wise to preserve flexibility in formulating their fiscal agenda.

One editorial remark is related to the title of Box 3, on p.14 of the main paper. This box is devoted to the risks of sharp slowdown in economic activity in the United States. It deals with a possibility of a "boom-bust" scenario, significant and abrupt increase in interest rates, and sharp correction in the stock prices. At the same time, the recent World Economic Outlook uses "smooth landing" as the baseline scenario for the United States. I would remove the words "World Economic Outlook" from the title.

As for the issue of publication of FSSA report raised by Mr. Bernes, I am in favor of having a general rule for publication of such reports, and not the decisions on a case-by-case basis.

I wish the Canadian authorities success in their reform efforts.

Mr. Spraos made the following statement:

Canada is one of an increasing number of economies that have been performing well over a long number of years, albeit in the case of Canada with occasional brief dips. I am delighted to share Mr. Bernes' evident pleasure at Canada's performance. In performing so well, these economies have left estimates of output potential, NAIRU, etc., panting well behind. They can now only serve as lagging indicators of performance. If you want to know how your unemployment was doing a year or two ago, look at the recent slope of the time-path traced by successive NAIRU estimates.

As usual, in this instance more than usual, a wide margin of error is associated with major policy charting. The staff acknowledge this and, with all due humility, are circumspect about their pronouncements. I welcome this.

On monetary policy they say that "with few signs of inflationary pressures, [it] should aim to permit the economy to reach its productive potential but the challenge will be to gauge the point at which policy will need to shift towards tightening." I would only wish to add an explicitly symmetric interpretation: that tightening too soon should be avoided as much as tightening too late. That statement sets the policy problem. Regarding policy prescription, the staff agree with the authorities that "the near-term aim of monetary policy should be to allow the economy to find its productive potential without compromising the official target for inflation." This is an example of language that I characterized as "circumspect," which I meant as a compliment. It is language consistent, I think, with the symmetric interpretation, of which I declared myself in favor.

I am also in favor of the Bank of Canada's practice, described by both the staff and Mr. Bernes, of taking into account a multiplicity of indicators and pieces of evidence in the course of pursuing inflation targeting. We have come a long way from the time when the price level was a function of only one argument—the money stock.

On fiscal policy this chair commended last year the fiscal consolidation that had been accomplished and favored the application of surpluses to debt retirement. A major reason given for this was that it would give a firm base for the operation of counter-cyclical fiscal policy, especially at times when the interest rate might be preempted by exchange rate concerns. In this context I must confess that I do not find clear guidance on what the authorities position is on the counter-cyclical role of the Budget. One interpretation of what I read is that a limit to counter-cyclical policy would be set by the "prudence" and "contingency reserve" components of the Budget. Is this correct? If so, given that the sum of the two components add up to about ½ percent of GDP, I would guess that such a limit would barely accommodate the full operation of the automatic stabilizers, even in a mild recession. I would find this uncongenial and I would welcome clarification.

I think it is right that we should be mindful of the deflationary risk right now. The prolonged high growth rate in both Canada and the United States (and indeed elsewhere) has been sustained by a diminishing household savings ratio, fuelled by the rise in asset prices. The latter is due for a prolonged pause, at the least. A mere pause will lower the consumption growth rate because that part of it which is sustained by rising wealth will vanish. Much worse would befall if asset values fell and stayed down for some length of time. I have no idea what the probability of that is but even a small probability of a big shock still needs to be seriously pondered about. The authorities are said to be ready for any eventualities emanating from the United States. But I would not like to be in their shoes if markets go sour in the United States, especially if their room for fiscal maneuver does not extend even to the full play of automatic stabilizers.

I must make clear, however, that I am concerned with risks to the macroeconomy, not to the financial system. Like the staff and, I think, everybody else, I believe that the Canadian financial system is so robust that, barring a cataclysm, it can ride any macroeconomic storm. Canada came out, as might have been expected, with flying colors from the FSSA exercise.

Lastly, I want to say that the staff's recommendation for so-called experience rating of unemployment insurance contributions has left a mark on me. I therefore have a suggestion to make. The scheme should be extended to pensions. The burden on the economy that each pensioner imposes depends on low long he lives. My suggestion is that the pensions component of social insurance contributions should be experience rated. Those who, under a number of crude but well-known criteria, have a higher life expectancy should pay higher contributions. This will internalize the costs they are likely to impose on the economy. By giving them, in this way, incentives to take up heavy smoking, alcoholic drinking, boxing and similar pursuits in order to get themselves reclassified into a lower contributions class, this measure will reduce the average length of time over which pensions are drawn and will thus alleviate the aging problem. To round off the scheme, a further discount on contributions should be given to those who sign an undertaking that they will forgo medical treatment for lung cancer, cirrhosis of the liver, brain damage, etc. I commend this scheme to the Canadian authorities!

Mr. Carstens made the following statement:

After analyzing in detail Canada's report for the 2000 Article IV Consultation and the corresponding to the FSSA, one cannot but congratulate both the staff and the Canadian authorities for a superb job. The staff in preparing outstanding documents in terms of content and clarity, and the Canadian authorities for squarely tackling the main problems that have affected Canada's economy. The skillful management of the main macropolicies to achieve internal and external equilibrium in an efficient way, coupled with a persistent attack on Canada's structural problems, have rendered outstanding results in terms of achieving sustainable growth with reduced inflation, without inducing vulnerabilities in other sectors of the economy.

As Mr. Bernes puts it in his preliminary statement, the main challenge that Canada faces nowadays seems to be to uncover the formula to perpetuate the virtuous cycle it has entered during the last years.

Given that I share in general the trust of the reports presented, I would like to limit myself to make a few comments and posing some questions for the staff and Mr. Bernes.

The Canadian authorities ought to be commended for the impressive turnaround in the public finances, particularly owing to their effort to institutionalize an open multiyear discussion of the fiscal perspectives of the country, which certainly will lead to enhanced discipline. The only aspect that I thought was not dealt with enough care in the report was the fiscal implications of the health care system. The staff mentions this issue in passing briefly, as it reminds us in the policy appraisal section about the "looming uncertainties regarding the longer-term fiscal cost of an aging population, especially in the area of health care." An actuarial evaluation of the health care system, considering the epidemiological transition of the country, would have been more in tune with the quality of research provided all over the documents, and certainly it would have shed some light about the appropriateness of saving or spending the emerging fiscal surpluses of the coming five years. The staff comments on the potential fiscal pressures derived from the Canadian health care system would be welcome.

In more than one section of the documents, the staff expresses uneasiness about the potential financial consequences of a sharp equity price correction and economic slowdown in the United States. Contributing factors would be the integration of Canadian banks with the non-financial corporate and financial sectors in the United States, which has led to increased on-balance sheet and off-balance sheet exposure. Two questions on this respect:

How serious is this vulnerability? Details about the staff concerns would be welcome. What are the Canadian authorities doing about this situation?

In closing, I would like to reiterate my congratulations to the Canadian authorities, wishing them well in their quest to perpetuate accelerated growth with insignificant inflation.

Mr. Szczuka made the following statement:

I would like to thank the staff for the interesting set of papers and Mr. Bernes for his preliminary statement. The Canadian economy has performed well. There is no doubt that the Canadian authorities have contributed to this success with their economic policies. I would like to congratulate Mr. Bernes for a job well done. Given that there are no storm clouds on Canada's 12-month horizon, the staff's growth estimate could be revised. However, Canada's outlook still depends to a large degree on its neighbors to the south.

Assessing the development of the U.S. economy will thus be an important element in underpinning Canada's macroeconomic policies. The staff could devote more attention to the similar developments in those two countries, such as the personal savings rate decline, as well as their differences.

Internal factors, such as changes in unemployment insurance, make forward-looking macroeconomic policy difficult. I agree with Mr. Couillault that the staff could review the low potential growth level of 2.25 to 2.5 percent in light of the changes in the United States. I am still surprised that the unemployment rate is at about 8 percent. I agree with the authorities and the staff that monetary policies should attempt to allow the economy to slowly converge toward its productive potential.

The key question is when to change gears. As Mr. Spraos pointed out, this should not happen too late or too soon. The key question is how early the authorities would be able to recognize that the potential has been reached, and on the other hand deal with the lag in monetary policies. Could the staff comment on how the authorities can look for early warning signals that the economy is turning and thus apply some monetary instruments?

Caution is in order, because there are some signs that inflation started to rise in 1999, even though the exchange rate appreciated by more than 4 percent. This was particularly visible in the overall Consumer Price Index. I wonder whether the staff could shed some light on real estate prices, because there is no mention of that in the staff report. I welcome the announcement by the Bank of Canada that more emphasis will be placed on a broader range of indicators. I also welcome the fact that updates to the monetary policy will be published twice a year.

I agree with the authorities about what should be done in case U.S. interest rates increase, although clearly the developments cannot be completely isolated. Canada’s independent monetary policy and its resulting flexible exchange rates have served the country well, which could be seen in exchange rate developments in the face of recent shocks.

I commend the authorities for their efforts at fiscal consolidation. A personal income tax reduction would be impractical at this stage, which is why I favor the option of attempting to reduce the public debt. The authorities are facing a choice between reducing the debt or increasing spending, giving in to political pressure. There is no easy solution, but I prefer the path of debt reduction. The staff is not fully clear on its advice.

The tax rate does seem to be high for middle- and low-income families. The example given in the staff report of a 60 percent income tax rate for those earning $30,000 is quite shocking. The fact that the income tax burden tends to increase under the current system compounds this effect. I am not convinced that indexation is the solution to this problem. Such a practice is not universally applied in other countries; the question is whether it would work better in Canada.

Unfortunately, Canada’s unemployment continues to be a dark shadow. This points to the need to roll back the reforms of the employment insurance schemes and social assistance at the provincial level, and to remove inter-regional barriers to work, goods, services, and capital. I was surprised to learn that residency requirements and the recognition of qualifications remain a barrier to labor mobility. The implementation of international agreements should be accelerated and could enhance trade and mobility within Canada, establishing a more efficient domestic market. We encourage the provinces and the federal government to make more progress on this issue.

I commend the Canadian authorities for the excellent quality of economic and financial data that they have released and for their high degree of transparency. I was not surprised to read that the stability assessment for Canada is good and that the financial system is in compliance.

I would ask the staff to clarify whether there are still restrictions on foreign banking, and whether the efficiency of the Canadian banking sector is improving.

I also support Mr. Bernes' call to allow the publication of the Volume 1 of the FSSA.

I wish the authorities all the best in the future.

Mr. Woolford made the following statement:

I agree with the approach advocated by the staff that both debt reduction and taxation reform should be top priorities for the authorities. The authorities also need to be mindful of the looming responsibilities of the aging population. In this regard, new initiatives should be lower priorities than the tax reform.

It might be useful to be a little bit hard-hitting towards the Canadian authorities and mention the tax break for sport teams. That situation demonstrates the pressure that governments with surpluses can come under. As it was, the reaction of the Canadian was to oppose the populist political suggestion, which is an encouraging result.

There have been commendable efforts at fiscal consolidation at the provincial level, which may be illustrative to other member countries. More information on this issue may have been useful. Second, I agree with the point made by Mr. Bernes that the budget consultation process has benefited from five-year estimates. This has helped focus the debate. There is little to be said on monetary policy; the authorities have performed particularly well in that area. They do face uncertainties about where the potential output lies. Ms. Lissakers and Mr. Sobel warned about putting on the brakes, although backing off the accelerator may be prudent, especially given the recent output numbers.

We agree with others who have raised concerns about the issue of trade liberalization in agriculture, clothing, and textiles.

Mr. Tornqvist made the following statement:

The Canadian economy has expanded for eight successive years. As noted in the staff reports and Mr. Bernes' preliminary statement, the economy has bounced back from the financial markets' turmoil of 1997–98. Acceleration in economic activity reflects both improved external conditions as well as pick-up in the domestic demand. The surge in commodity prices and the strength of the U.S. economy are keeping growth opportunities in the upside. Substantial investment in new technologies may have raised the rate of potential growth, and has perhaps added another point in the score for the advocates of the "new economy." Not surprisingly, the unemployment is hitting its lowest level since 1981.

Continuously low inflation and improved fiscal performance at all levels of government have supported a strong rebound in the growth. Indeed, the Canadian authorities have demonstrated skillful macroeconomic management and dynamism in implementing the structural reform agenda. These achievements deserve acknowledgment.

Regarding the near-term outlook, I am in broad agreement with the staff appraisal. I focus my specific comments on the fiscal policy. As the staff notes, decisive efforts by the government have produced a dramatic turnaround in the federal fiscal position. Accompanying fiscal consolidation at the provincial level has brought the general government's budgetary position from a deficit of -5.5 percent of GDP in 1994 to a surplus of about 1 percent of GDP in 1998. The fundamental question, as also is raised by others, is how the fiscal surpluses could be best used?

My preference is tilting in favor of debt reduction. The economy is performing strongly and thus there is no need for the additional fiscal stimulus, at least in the short run. Second, in the wake of growing pressures to increase spending, additional expenditures might end up in non-productive projects. It may also send a wrong signal to the provincial authorities for the relaxation of their fiscal stance, which might undermine the long-term fiscal objectives. Under these circumstances, the paying down of high public debt seems a reasonable solution.

As an additional safeguard, the Canadian authorities may wish to consider the possibility of introducing explicit expenditure ceilings in the medium-term budgetary framework. This would make ad hoc spending of surpluses more difficult. We found expenditure ceilings efficient in Sweden then facing a similar situation in determining the use of fiscal surpluses.

This being said, I also share the view that income and corporate taxes need cutting, particularly given the relatively high marginal tax rates in Canada as compared to its peer countries. As debt and tax reductions are in essence complementary to each other, the whole issue boils down to the timing. I concur with the staff, and see some merit in saving somewhat more than the authorities seem to prefer at the present stage. In my view, this would position Canada better were the positive external conditions to turn unfavorable. It would allow phasing in of a fiscal stimulus at a later stage, should the circumstances so warrant.

Let me also make a short comment on the FSSA reports. I found the two-volume compendium as an extremely useful supplement to the Article IV report. As expected, the Canadian financial industry and supervisory system received high marks. This is entirely consistent with the authorities' overall excellent track record. Likewise, it does not come as a surprise that the Canadian financial sector and regulators are faced with new challenges originating from financial innovation and growing international exposure and competition. The authorities' determination to address these challenges is reassuring.

With these remarks I wish Canadian authorities continued success.

Mr. Yakusha submitted the following statement:

Abundant evidence suggests that over the past decade more and more countries—covering the whole spectrum of economic development—have embarked upon macroeconomic and structural policies aiming at increasing the overall performance and long-term sustained prosperity. Canada proved to be among the best performers among those successful industrial countries. Over the past year its achievements have been impressive, replicating the earlier trends. The staff report, supported by related papers, provides substantive evidence: economic growth remained robust, unemployment rate declined to the lowest levels in decades, with corresponding gains in productivity, inflation remained within the lower end of the 1–3 target range, the Canadian dollar tended to recover from earlier depreciation, and the current account deficit declined sharply. Perhaps more reassuring, the fiscal position improved further, adding to the increased market confidence in government policies. The current challenges rest, in my opinion, less in a likelihood of major world markets turbulence and more in the U.S. economic fortunes. One hundred and seven consecutive months of economic growth in the United States is, of course, a very impressive achievement, but it also highlights the fact that a probability of some market correction may not be excluded.

As far as monetary policy is concerned, I share the authorities' approach—supported by the staff—that the short-term objective should be to allow the economy operate close to its potential while providing a convincing inflation record. Here there are few lessons or recommendations to be provided; in fact, the actual conduct of monetary policy in Canada is more an art and less a technique. As a matter of orientation, I support the view that monetary policy might be tightened gradually. The latest inflation figures suggest the need for prudency. And the recent upward trend in interest rates seems consistent with this approach.

On the previous Article IV discussion on Canada we commented on the large official interventions in the foreign exchange market and the needed coordination with interest rate policy. I feel now more confident that the Bank of Canada has opted to refrain from intervening to guide the exchange rate, thus placing the currency closer to its market value and allowing the exchange rate to work as a shock absorber, as pointed out by Mr. Bernes in his helpful preliminary statement. We would also like to note that the impact of Canadian dollar appreciation on external competitiveness seems to be offset by productivity gains.

Equally challenging are the policy options for fiscal authorities. In his preliminary statement, Mr. Bernes reinforces the firm intention of the government to use the budgetary surpluses to reduce its debt and cut taxes. The possible split between the two may not be decided yet. staff's views on the optimal or desirable ratio are not clearly stated, as it seems. The Contingency Reserve, if not used up for other prescribed purposes, could be applied to reducing the debt—as we understand the policy. The softer indication is not disturbing to the extent that in case of need, the resources to cut the debt are available. As far as the options to save the surplus or to spend it, I fully agree with the practical approach taken by the authorities, and endorsed by the staff; a clear account of this approach is presented by Mr. Pickford and Mr. Burgess in their preliminary statement. Indeed, there is less an exclusive option and more a combination of options, depending on the economic circumstances at the time. Market sentiment could be also taken into consideration when deciding to tilt the balance toward one of the options. I tend to side the view that market confidence could be further cemented by a firmer commitment toward debt reduction.

Let me make a final comment on the Financial Sector Stability Assessment for Canada. The paper makes an excellent account of the Canadian financial system. At the same time it concludes that the financial system is among the soundest in the world. This is highly commendable and reflects the permanent care to adapt the regulatory framework to market developments. While I would not comment the authorities' ownership rules (in particular, the rule that the largest financial institutions must be widely held), I would be interested to know the staff's or Mr. Bernes' view on the implications of the existing regulatory framework in the financial system on the competitiveness of Canadian financial institutions. Has staff any assessments on how the recent changes in regulations (allowing foreign bank branching) will affect the banking system?

Mr. Costa made the following statement:

On the question of how to dispose of the fiscal surplus, I share the staff's view that debt reduction and income tax reform should be top priorities. I was concerned by the last sentence of Paragraph 31 in the staff report mentioning the debate within the government over the ex post use of the contingency reserve for debt reduction, implying that only because of the importance attached by the financial markets to debt reduction had the authorities been able to maintain their present course. The staff's comments would be appreciated.

I would also appreciate the staff to comment regarding the concept of the net debt. When we discuss the general level of indebtedness of emerging markets or developing countries, we are usually faced with gross debt figures. Here the staff presents us with net debt figures, without the gross amount, nor what has been removed to arrive at the net amount. If the staff would have used gross figures, perhaps the call for a more rapid reduction of debt levels could have been more forceful. In any event, a greater uniformity of statistical treatment among member countries is called for.

Regarding monetary policy, I side with those that call for caution regarding the testing of the limits of non-inflationary growth. With projected rates of growth for the current year well above the potential rate, and with an output gap that, according to Bank of Canada, was close to zero for the third quarter of 1999, a continued testing of the limits of capacity could entail a marked disbelief in those figures derived from the potential output. The authorities' assertion that those indicators were not useful as a guide to formulating policy could be understood, indicating their willingness to take some risk to test the limits of growth. The authorities, however, are risking a great deal if they reach the limit sooner than expected. Having downplayed the importance of the MCI index and brought into question the relevance of output indicators, the authorities leave the public without a clear objective indicator of the substance of monetary policy.

It is significant that the governor of the Bank of Canada in a recent speech mentioned at the top of the list of indicators used to assess inflationary pressures the expected movements in actual inflation and changes in expectations in future inflation. Those are simply manifestations of underlying factors, rather than factors themselves. It goes without saying that the expectations of future inflation are closely linked to the credibility of the authorities in keeping inflation within the targeted range, which is quite good, owing to their superb performance so far. It is questionable how much of this good performance is owing to the authorities' skillful management or to some other underlying factors, such as the impact of open global markets on the price of tradables. In any event, the authorities' credibility allows them to test the limits of growth and to be somehow less specific as to the actual indicators. This credibility is the most valued asset that the authorities have, and they should act with extreme caution not to undermine it.

In the present circumstances, with the economy at or close to full employment, a continuously stable environment, improved strength, a negative interest rate with the United States, and the likely announcement of a personal income tax cut, aggregate demand may well drive to unsustainable levels. Thus, pressure on wages could force the authorities to substantially tighten monetary policy. To reduce the negative effects, the authorities should closely follow the path that has been expected by the markets.

Finally, regarding Box 2 on Canada-U.S. economic integration, the staff points to impressive indicators showing greater integration among the two countries. Mr. Bernes in his preliminary statement considered this integration strong evidence that the flexible exchange rate regime fulfills an important role in the Canadian economy. That may be true, but it is also true that the importance of real shocks vis-à-vis those stemming from the capital account have been diminishing along the path of globalization. Among the seven indicators of Canada-U.S. economic integration, those related to the capital account are among the highest.

Mr. Kelkar said that the data in Table 1 of the staff report, showing gross investment in the 1960s, 1970s, 1980s and 1990s, had indicated that the real terms of gross private investment rose sharply in the 1990s, while there was no such change in the growth rate. Could the staff comment on what was happening in that case? There also appeared to be a similar discrepancy in the difference between gross and net investment over the four decades. Was there any link between that situation and the productivity paradox that the staff had highlighted?

The staff representative from the Western Hemisphere Department said that the authorities' medium-term plan had two built-in elements that would already allow for automatic stabilizers. There was a contingency reserve on the so-called economic prudence, which amounted to about 0.5 percent of GDP. In a particular year, that would allow for automatic stabilizers with an order of magnitude of a 2 percentage point deviation of GDP from the trend path. That was a moderate size downturn. If there were a more severe downturn like in 1990 or 1991, that would exceed the contingency. The authorities had not been explicit as to what they would do in that case, but were expected—and had been recommended by the staff—to temporarily run a deficit. That the authorities were bringing down the debt level enhanced the scope for such counter-cyclical policies. The staff's medium-term projections had not built-in a normal cycle. The projections did not assume that the country's economy was at potential but was below potential. The question was if there were a severe recession, what would be the response of the discretionary fiscal policy, going beyond the stabilizers. In that case, some of the elements of the tax reform might need to be accelerated.

The authorities were currently faced with the question of how to handle the automatic stabilizers on the upside, the staff representative continued. Because of the strong economy, there was a larger surplus envisaged in the contingency reserve. In the previous couple of years, such additional expenditure measures had been put toward special programs at the end of the year, such as a millennium scholarship education program. The question was whether to use the funds for that or for debt reduction. The staff's policy advice would be that given the strength of the economy, any over-shooting of the surplus should be used to pay down the debt, rather than pay for additional spending measures. It was not known what the authorities would decide; some possible end-of-year spending measures had recently been discussed in the media.

As the authorities considered additional tax and expenditure measures in the years ahead, they should bear in mind that the projections contained in the medium-term update assumed an increasing real burden of taxation, because the system was not indexed, the staff representative noted. Given the high tax burden and the tax bracket creep that had already taken place, it seemed to be appropriate to index the tax system, either through legislation or through ad hoc adjustments. That indexation was not expected to cause problems for the monetary policy or send inappropriate signals to the markets.

Targeted tax cuts could be used to reduce the cost of unskilled labor, the staff representative noted. One of the best ways to do that was to make further reductions in Canada's unemployment insurance system. Those rates continued to be somewhat higher than the break-even level, and reductions were advisable. Over the previous year there had been decisions on the benefit side to address some of the costs of that system. The issue of moving to an experience rating system was also relevant in that context, as there were tax subsidy elements implicit in the employment insurance system that shifted the burden from some sectors to others for no obvious reason. That was one of the reasons why structural unemployment remained high in Canada.

The potential fiscal costs of the rising cost of health care had been addressed two or three years previously in the staff reports, which was why the staff had not dealt with the issue at great length, the staff representative explained.

Mr. Szczuka said that it was important to address the issue of the tax bracket creep, and whether it was a result of legislation or discretionary measures. It would be preferable if the authorities had the discretion. The issue could also be addressed by adjusting the marginal tax rate, which could bring better results in terms of stimulating the economy. Was there much movement between the rates in Canada and the United States? That would be an important argument in favor of reducing taxes.

The staff representative from the Western Hemisphere Department said that the staff had prepared a paper the previous year on the brain-drain from Canada to the United States. While the implications of the brain drain were significant, it was not the principal cause of the loss to the tax system, particularly regarding lower and middle income groups, where the disincentives to work were probably more relevant. The cross-border issue was more important for the taxation of corporate income. In that respect there was a major need for harmonization or moving closer to U.S. rates, because there was enormous scope for mobility.

Canada faced a structural problem in that it required somewhat higher expenditure levels than the United States, and yet it faced the issue of how to handle losses associated with mobility or factors of production, the staff representative continued. Probably in the long run it would have to deal with that structural problem by moving toward harmonized business taxation rates and harmonized personal taxes. It would have to use consumption taxes such as the sales tax and the GST to compensate for its somewhat higher government expenditure levels. That was the debate currently taking place in Canada.

Regarding the financial sector, the staff had included the main messages of the FSSA review in the Article IV report, the staff representative noted. The system was sound and stable, and there were no major vulnerabilities. Some issues identified had been associated with managing risks in rapidly changing financial markets, which were common to most advanced financial systems and not peculiar to Canada. Those had been well-covered in the various staff reports, which were all part of the Article IV consultation papers.

Mr. Couillault commented that the staff had done a good job of assessing Canada's financial sector. However, the FSSA review was not discussed. There were two explanations for that. One was that Canada's financial system was in good shape and the supervisory authorities had done a good job. The other was that the staff had had difficulty dealing with that complex issue. It was important for the staff to give a complete picture. For example, there was no indication of any follow-up or additional research involving the FSSA review.

The staff representative from the Western Hemisphere Department emphasized that the various papers were all part of the Article IV consultation. All of the issues raised, for example the segregated funds of the insurance company, were part of the Article IV process and would be pursued. The authorities had already taken some action during the process of the consultation discussions, which had been reflected in the reports. The authorities had told the accounting and auditing profession that if they did not deal with the matter, regulations would be issued.

The staff representative from the Monetary and Exchange Affairs Department (MAE) said that they had looked to Canada as a source of best practices and their findings from the Canada FSSA had generally informed the FSSA process. A more general lesson from the FSSAs would be discussed in the paper brought to the Board in March 2000, reviewing the pilot project. The staff had had a dialogue with the Canadian authorities throughout the process, which had produced some modifications of their approach to the regulation of segregated funds and the introduction of specific capital and reserve requirements, which had earlier been identified as a potential vulnerability.

The staff representative from the Policy Development and Review Department said that in the program outlook notes that the Board had received as part of the budget documentation, the staff had provided resources for the FSSA program follow-up. That was in addition to the full FSSA work indicated in that documentation. If the Board decided to move from the pilot phase, the staff preferred to follow-up on individual countries on a periodic rather than an ongoing basis.

Mr. Bernes said that on this point there was a clear need for a follow-up process. As he understood some of the questions, it was just the magnitude of information and of the exercise. This was an issue that would need to be discussed when the first series of FSSAs were reviewed. It was a very good exercise and had worked well with those engaged in the review. But as one of the first efforts, there would clearly be lessons to be drawn from it. There had been some discussion with the staff as to the scope of the exercise, which imposed enormous costs both for the staff and for the Canadian authorities, although it was not easy to narrow that scope. One could identify areas where the resources could be limited, although then there was a risk that something would be missed. It was important to get the best product, at the most reasonable cost, presented in a way that was most manageable for the Board to consider.

The Acting Chairman said that the FSSA exercise was technical and complicated. The Board would not want to discuss it in detail in the same way that the Article IV consultation was discussed. In the end, the system should be strong and well supervised, with relatively few problems. There would be cases where the section on the FSSA was a good deal longer than it was in the case of Canada. The Board would have to figure out at the time of the evaluation of the FSSA reviews in March 2000 whether to change its present approach. Could the staff say whether there would always be an association between the FSSA review and the Article IV consultation?

The staff representative from the Policy Development and Review Department said that in the case of Canada, the mission for the FSSA had been close to that for the Article IV consultation. It would be better to have the work on the FSAP and FSSA completed before the mission on the Article IV consultation began its work, so that it was much more a part of the planning process.

Mr. Kiekens said that the issue before the Board today was Mr. Bernes' request to publish the FSSA assessment. One approach was to say that it was an integral part of the Article IV consultation, and if the country published its Article IV papers, it would also be allowed to publish that assessment. Another was to say that it was a totally different exercise. In that case, the Board should decide how to deal with an individual request for publication.

The assessment of the financial sector was an integral part of the Article IV consultation, Mr. Kiekens considered. However, that raised a number of other issues, for example: could a country decide to publish the main Article IV consultation and not the assessment? In principle, if the country decided to publish the Article IV consultation, it must also publish the financial assessment, because it should not have the right to pick and choose what part of the Article IV consultation report was published. The Board had not reflected on that issue when it had launched the pilot project on publication. When the Board had discussed that issue for the first time, there was much talk of discretion and confidentiality, but not about how complex the framework was. For example, the paper on Canada included tables that dealt with sensitive issues. Table 3 gave the Bank of Canada's calculations about the country's vulnerability or the effect of interest rate changes and devaluation changes on its operational expenses and capital. The difference between the Fund's calculations and the bank's calculations was striking, even though it could be explained. But would that be obvious to the external reader? There were also interesting numbers related to other countries, for the sake of comparison. How could Canada decide to publish a document where there was data from other countries that had not necessarily been published in those countries?

If the assessments were published, they should not be sanitized in the papers that the Board could never see, Mr. Kiekens continued. The box at the beginning of the assessment paper mentioned that the FSAP report, which the Board could not see, contained detailed institutional information and analysis and a comprehensive assessment of the international standard that would be transmitted to the authorities in approval of their funds management. There should be transparency to the outside world as well as internally.

The paper on Canada was different than the assessment paper in that it gave detailed institutional information, Mr. Kiekens remarked. What was so sensitive or confidential that the Board could not see it? There was a comprehensive analysis of the observance of international standards. It was hard to see, therefore, why it should not be shared with the Board. The pilot program was a co-chaired initiative by the World Bank and the Fund, and in principle the paper needed to be approved by both. Had the paper on Canada been approved by the World Bank management and, if so, why was that not mentioned?

The staff representative from the Western Hemisphere Department said that there were no significant constraints on foreign entry into Canada's financial sector, other than a restriction on bank branching, which had been lifted. However, for large banks there were widely held ownership requirements which limited to 20 percent the proportion of equity in those banks that could be held by a single investor, be it a domestic or foreign investor. That implied that a U.S. or another foreign bank could not take over a large bank in Canada. There was a proposal to raise that limit under the next stage of financial sector reforms, but it would still pose a constraint.

The lags with which Canada's monetary policy operated were sufficiently long that there was little that could be done by the time leading indicators displayed problems, the staff representative noted. The Bank of Canada conducted monetary policy looking forward six to eight quarters, reflecting its judgment of the effect of monetary policy on the economy. Regarding asset prices as indicators of inflation and what had happened to real estate prices in particular, in Canada there had not been any significant deviation between housing prices and the overall CPI. Housing prices for the largest 21 cities in Canada had not shown any substantial acceleration beyond general inflation, and were even somewhat less than in the United States, where there had been a pick-up.

The financial systems of Canada and the United States were increasingly integrated and the Canadian economy was therefore vulnerable to a U.S. slowdown, the staff representative remarked. There had been an increase in the exposure of the Canadian financial system to the United States; about 17 percent of Canadian lending was done to the

United States. There would therefore be a substantial impact on bank profitability and on the broader economy if there was a slowdown in the United States. The Canadian authorities, however, would rightly point out that it was good to diversify, even if that mean diversifying into the U.S. economy where it would be vulnerable to events there. It was riskier to keep all investment within Canada. There was not much that the Canadian authorities could do about the vulnerability to a U.S. downturn, beyond using macroeconomic tools to conduct counter cyclical policy and making sure that there were appropriate risk management systems in the banks.

Mr. Carstens asked the staff to be more specific about the nature of Canada's vulnerability to a U.S. downturn. It had been reiterated in the staff paper that if the U.S. economy slowed, it would have an impact on the financial sector and its profitability. It would be illustrative for the staff to elaborate on why that was a problem. Would the Canadian loans to American corporations generate an interest in the past due loans and other commercial reserves? Would the losses come through trading in derivatives? Did the Canadian banks have an exposure in their portfolio of U.S. stocks? Had they lent foreign investors money to have a leveraged position in the stock market?

Mr. Szczuka said that regarding the balance of payments, while there was an increase in direct investment of more than 10 billion Canadian dollars, there were also large capital outflows. One compensated for the other. To what extent could the current foreign policy continue? What were the possible reasons for the switch in direct investment by more than 26 million Canadian dollars?

Mr. Sobel said that the Canadian economy would be heavily influenced by that in the United States, which was both good and bad. There were global vulnerabilities, and most countries were influenced by developments elsewhere. It was important to promote balanced global growth, not just growth vis-à-vis the United States.

The staff representative from the Monetary and Exchange Affairs Department said that the staff had identified credit, liquidity, and market risks regarding the exposure of Canada's major banks in the United States. The concern over the credit risk reflected a more general concern about the recognition of the credit quality of the bank portfolio, although that was difficult to quantify. The derivative exposure and the market risks related to the appropriate handling of the off-balance sheet risk. It was not possible to look at the specific risk exposure because that involved extensive proprietary information. The staff could look at the systems of overseeing the risk management of the banks themselves, and had spent considerable time with the regulators examining their approach to assessing the banks' risks. The regulators had a specific risk-centered approach that sought to identify the major exposures and targeted inspections when there were concerns. The staff also spent a considerable amount of time on the task required for the validation of internal models and controls in the banks to make sure they were adequate. Those approaches were fully consistent with the best international practices for handling those types of derivative exposures.

In that context, the banks had not been seriously hit during the LTCM crisis, the staff representative continued. There had been some testing of the models during that period, and losses had not been significant. However, there were still potential weaknesses of those models, which were recognized internationally.

The liquidity risk was larger in international exposures where the banks were being funded through international markets, the staff representative noted. In Canada, the banks had been upgrading their systems partly because of shocks related to the referendum in Quebec. Those particular contingency planning systems had been examined and deemed adequate.

Another staff representative from the Western Hemisphere Department said that the growth potential for Canada had been motivated in part by some misunderstanding of the revised estimates for the United States. Those estimates had not reflected the staff's reappraisal in terms of investments in new technologies. It had instead looked back at U.S. growth using a variety of different structural and timing techniques and had re-estimated the potential growth. Estimates done in the mid-1990s had pointed to a slowdown in U.S. growth at the end of the 1980s from 2.75 percent to 2.25 percent. When the staff looked at that in the summer of 1999, it had discovered that that slowdown did not exist in the longer series of data. Currently the staff would revise potential growth for the United States upward to 3 percent, roughly reflecting the revisions in the U.S. national income accounts.

In the context of Canada, there was no surprise that there was a consensus view between the Fund staff and the Bank of Canada, the staff representative continued. The two were dealing with the same time series for the GDP and using the same techniques in terms of calculating GDP. There could be some suggestions that potential growth may be raised, based on recent performance, which led to the question of whether there was a new economy in Canada. The staff was relatively conservative on the question of whether there was a new economy either in Canada or the United States. While the changes in technology were probably contributing to an increase in potential growth and productivity, it was not clear how much time was required to bring about a substantial increase in productivity. It could take several years for all of the benefits from those changes to be fully reflected.

There had been a tendency to keep moving the NAIRU estimates down in line with the latest observations on the unemployment rate, the staff representative noted. The staff's current estimate of the NAIRU was 6.5 percent, not 8 percent. Part of the reason for changing the estimates in the context of Canada was the structural changes in the employment market and related employment scheme reforms. Unfortunately, the tools available to measure a concept such as the NAIRU were weak and data-intensive. Only in five to ten years could it be said with certainty what the NAIRU was today.

The sharp rise in real investment reflected the fact that the relative price of capital had declined dramatically, particularly with the adoption of computers, the staff representative reported. Gross and net investment also reflected that change, because the average age of the capital stock from the 1960s to the 1990s had decreased considerably in the United States and Canada. The numbers in the tables, if the net investment number was adjusted to a real basis instead of a current dollar basis, would show an increase in real net investment over that period. The decline in the price of capital also meant that for each dollar of savings, more real capital could be bought. Thus, in order to achieve a certain real level of the capital stock, less national savings was needed. The decline in the savings rate was therefore not necessarily disastrous, given the change in the relative cost of capital.

The pressure from health care services had been examines and analyzed in detail by the staff two years ago, the staff representative noted. There had been some key problems in trying to make such estimates, because of uncertainties regarding a number of variables involved. The staff had therefore produced a wide range of estimates, which produced results ranging from the conclusion that Canadians would have no problem in the long term to the conclusion that a major disaster loomed. The main reason was that expenditures on health care were difficult to predict. Changes in health care technology could either add to or reduce costs. The staff had broken down its estimates by age, and had found that in terms of real expenditure per person, in cohorts below 65 there had been no trend in real expenditures per capita, while above 65 there had been a definite upward trend. That, coupled with the demographic shift in the aging population, would put significant pressures on real health care spending.

Moreover, health care costs in Canada had been increasing on average about 2 percent more than the overall GDP deflator, the staff representative continued. It was difficult to assume that health care costs could maintain such a differential for a long period, but different assumptions produced a wide variety of results. Canada's auditor general had done an estimate with a 1 percent differential in health care cost relative to the GDP deflator, which suggested that the present value of health care cost would rise by 2.5 percent of GDP over the next 30 years.

Regarding the issue of experience rating, in any well-structured employment insurance scheme, there was a tendency to create some moral hazard, the staff representative commented. In establishing such a scheme it was important to minimize that moral hazard. The scheme that the staff had advocated in terms of introducing experience rating into the employment insurance system in Canada would reduce the moral hazard. That was reflected in the behavior of employers in industries with less stable employment patterns, where economic efficiencies would improve and social welfare would rise. That was not recommended for pension systems but for EI systems in Canada.

The Acting Chairman said that the issue of experience rating was widespread and had been used in many countries. Experience rating was not an outlandish idea. The matter should be taken up in further discussion with the Fiscal Affairs Department (FAD) to see whether the Fund should take a stand on it. There was a trade-off between efficiency and solidarity involved.

Mr. Kelkar said that in spite of investment in Canada, growth had declined in the 1990s. Could that be related to the different mix of public investment? In the 1960s, 1970s, and 1980s, there had been a larger share of public investment in infrastructure in Canada. Had that contributed to growth? Should there be a larger share of public investments to ensure that private investment was productive and contributed to a larger growth rate?

Another staff representative from the Western Hemisphere Department said that there had been a considerable amount of economic literature trying to explain the productivity slowdown since 1970 in both the United States and Canada. The literature did not refer to the shift between public and private investment, however. Much of the more recent work instead had dealt with the adaptation of new technology and resulting learning process. In terms of the GNP, there had been a sharp decline through the 1980s in Canada, which had continued in the 1990s, albeit at a much slower rate. The United States had experienced a similar decline in the 1980s but the situation had improved in the 1990s. That might be a reflection of companies finally beginning to take full advantage of the benefits of technology.

Mr. Kelkar said that a number of papers had brought out the importance of public investment in stimulating the growth rate.

The Acting Chairman said there had been a large volume of work about a decade ago on the importance of large rates of public investment, but that principle had not been reiterated more recently.

The staff representative from the Monetary and Exchange Affairs Department said that ownership by a single entity in the financial sector was restricted to 10 percent, which under the policy paper would be increased to 20 percent. The staff had looked at the issue as a question of balancing domestic and international competition in the banking system. The system was already highly concentrated in the domestic market, while the banks did not believe they were large enough to compete on a broad spectrum in the international markets. There were a number of proposals to increase competition in the domestic market, by lowering capital standards and promoting the entry of new institutions. There was also a proposal to revise the proposed bank mergers rules to include international competitiveness as one of the elements in the authorities' assessment. The staff's proposal to address the dilemma between domestic and international competition, reflected in the FSSA documents, was to modify the rules to allow for mergers with international institutions. That would jointly deal with the question of domestic concentration and international diversification.

On the potential impact of an economic slowdown on the banks, in the last year a general provisioning requirement had been introduced to increase the amount of reserves that banks would have to hold against a weakness in their balance sheets. On the equity markets, the main concern noted was the segregated funds. Action had recently been taken to introduce new provisioning and capital standards against those risks.

The information in Table 3 had been taken from the annual reports of the banks, the staff representative reported. Part of the movement to improve transparency in the financial system was to encourage banks to publish more information, so the staff had included information in the table derived from the banks' own annual reports and had made calculations based on that published information. The staff had also derived information from a number of public sources and major agencies. The information in the FSSA report was therefore all publicly available, including that taken from international comparators.

There was no difference between the institution-specific information contained in the FSSA and Financial Sector Assessment Program (FSAP) reports, the staff representative explained. Regarding the difference between the assessment of international standards in the FSAP review, that was a much more lengthy document which went into considerable detail on the structure of the regulations, the nature of the supervisory system, and the way it had been applied. That assessment was fully summarized in Volume 2 of the FSSA Report.

The staff representative from the Policy Development and Review Department said that FSSA documents were not part of the documentation for the Article IV consultation in the sense that the selected issues papers were. The FSAP review had been launched as a pilot project jointly by the management of the Fund and the Bank to take place in the context of the Fund's Article IV surveillance. The question of whether it should become a fixed part of that Article IV consultation and the exact relationship between the FSAP and FSSA reports and the Article IV process was something that was to be considered by the Board upon the completion of the pilot program.

Looking at the circulation to Directors, there were clear differences between the FSSA and Article IV reports, the staff representative continued. The Article IV report was a staff memorandum which was circulated, while the FSSA had a more limited distribution, one copy per Director and Department head. One other difference concerned the confidential nature of what could be in the FSSA. It was not circulated to the WTO or the OECD. Thus, the FSSA documentation did not fall under the pilot program for the release of staff reports.

The question about confidentiality and transparency trade-offs had been presented in the progress report (SM/99/226), the staff representative noted. That had been discussed by Directors in October 1999. It was decided that questions of confidentiality versus publication would be analyzed at the time of the completion of the pilot project. The staff expected that that paper would be available for the Board discussion in late March 2000. It would examine the issues surrounding confidentiality and publication.

Mr. Bernes made the following concluding statement:

> Let me thank my colleagues, as well as the staff, for their comments, which focused on the critical issues that Canada faces. For the third year in a row, Canada will run a surplus, which comes after 28 years of deficits and raises some critical questions about the proper balance between debt reduction, tax reductions and expenditure increases. We have gone through significant program cuts. Program spending as a percentage of GDP is now back to the level of the 1950s, a phenomenal change, and the government is still shrinking. The question is what is the right size for a government, and the correct level of public expenditure? What is the right level of taxation? How does one balance that with the tax rates of one's neighbors? How fast does one pay off the debt? What are the trade-offs?

Related to those questions is the issue of monetary policy, which many Directors have raised. Is there a new paradigm? How does one walk the fine line between probing to see whether there is greater potential than earlier thought and increased inflation, given the lags involved and considering the decisions made on the fiscal side? There is going to be tremendous fiscal stimulus over the next few years, be it through tax reductions or expenditure increases, which further complicates the role of monetary policy.

Regarding the scope for letting automatic stabilizers work on the fiscal side, the contingency reserve is there to meet unexpected expenditures without putting the country back into deficit. However, if that runs out, the government cannot decide to go back into deficit. That would be a question it would have to face; clearly the faster one brings down the debt load, the greater the scope for temporarily going into a deficit situation.

We do not have expenditure caps at the national level in Canada, although some provincial governments have tried them. No parliament can be bound by the previous parliament, just as no Board can be bound by any previous Board decision. The question of where one goes on the expenditure side is critical. Some of the politicians think that happy days are here again, we have a surplus, and departments crank out their lists of priorities. Giving tax breaks to hockey teams was one suggestion, as hockey is a popular sport, it did not cost much, and some politicians thought it was a sure way to get votes and support. In the parliamentary system, though, when the government announces an initiative it must have the majority to put it through. There was a huge uproar, the issue dominated the radio talk shows and newspapers and people were shocked. Within 48 hours the government retreated, an extraordinarily rare event. That just shows the shift in the mindset. The population understood the situation, which spoke to issues of transparency, education, and consultation. It would be good if the staff could cover the situation in its selective issues to allow others to see how that process operated in Canada.

Health care is also an issue. Canada is dealing with escalating health care costs, which are putting stresses and strains on the health care system. We are wrestling with that. That will require some careful stewardship over the next few years.

Regarding the medium-term forecast, the current government, when it was elected, said that it would not go with a five-year forecast but a two-year rolling forecast. With a five-year forecast, it’s easy to assume away your problems, to avoid paying for the next government, while a two-year forecast keeps the government’s feet to the fire. But when the country moves from a deficit to a surplus situation, the picture changes. Everybody suddenly sees that there is a huge surplus to work with. However, while we may have a surplus this year, we may not have it three or four years down the road. It is difficult to get the public focused on making decisions regarding expenditures and surpluses in a five-year time frame. We have therefore gone back to putting out five-year forecasts to deal with the magnitude of the surplus and to look at the policy decisions that can be made, while at the same time maintaining the two-year decision-making process.

The staff mentioned a couple of decisions that the government had made regarding the surplus. There is a commitment to use some of the surplus for an millennium education fund this year, and to put money back into health care on a one-time basis. The issue is the economic benefit down the road. What sort of benefit does one get from a scholarship fund strengthening the education that young Canadians will receive and the social capital that will develop from that? What is the trade-off, compared with a faster pay down in the debt?

Very few governments have surpluses and this territory is fairly new to all of us. The answers are not obvious. The staff has tried for a couple of years to look at it. The benefit of a faster level of debt pay-off is something that the staff, and all of us collectively, need to pay more attention to in such circumstances.

The question of why Canada's unemployment rate is higher than that in the United States is a perennial one. There are not many differences in terms of participation rates, how unemployment is measured, and how the unemployment schemes work. The question could equally be: Why is Canada's unemployment rate better than Europe's? One of the problems in Canada is that the country is always compared with the United States, which happens to be a good performer in virtually every sense. Canada has a public policy process, which is probably why the tax rate is higher. The United States is one country; it might be more appropriate to compare Canada's unemployment rate with a broader band of countries.

Regarding index inflation targeting, there has been a perception that the Bank of Canada's emphasis on the MCI was automatic, that if the index moved one way, the bank would move. That is one of the problems of transparency and monetary policy, trying to make the markets understand what you are trying to achieve and what you take into account in order to achieve it. That is part of the problem that the U.S. Federal Reserve is wrestling with now; the markets were not able to understand its bias one way or the other. The Bank of Canada has always looked at a range of indicators and continues to do so. But the markets misunderstood the reference to the MCI.

I am not going to go into a long discussion on the flexible exchange rate; this is the 50th anniversary since Canada floated its rate, and it is a system that serves the country best. The Bank of Canada is organizing a conference on a retrospective of the system sometime this year, and some papers might address that issue.

On the questions regarding the time it has taken to implement the regulations in the financial sector, those regulations have now been published in the Canada Gazette, and we expect them to be implemented by the end of this month. The associated tax legislation is a priority for the government and it is expected to proceed shortly with that.

I agree that Canada should move to reduce its protection with regard to agriculture and textiles, although mine is not a popular position in the country. This is an issue which all industrialized countries collectively must respond to. It also indicates the sorts of problems that come up. Through fiscal retrenchment, Canada eliminated most of its subsidies in the agricultural area, so that now most of the protection is afforded through the tariff system. The OECD studies looking at comprehensive protection for agricultural products show that subsidies in the European Union remain high, while those in the United States came down and moved back up. That creates a tremendous debate in Canada; if these other major producers are going to subsidize, why should Canada not get back into the game? If we do not, it shows the inter-linkages and the pressures that any government could face in dealing with such a public policy issue. Collectively, it's important for industrialized countries to address protection in these areas, but it more important for emerging markets to have the possibility to exploit their advantages.

The publication of the FSSA report is different than the Article IV consultation. Governments should be able to decide to publish it on a voluntary basis. It would only happen once every four or five years. From the Canadian perspective, it will also be some time before the FSSA happens again, which is why we would like to release it. I recognize that is it easier for us to publish it, given that there are not sharp criticisms of our system. However, I do not think that our publication puts pressure on other countries to release their FSSA reports, because this is a different type of exercise than the Article IV consultation. This is a process which should be done on a voluntary basis for countries who so choose, once every four or five years. The staff has addressed the issues raised with regard to confidentiality, although there are two deletions that we would, for market sensitivity reasons, suggest to the staff. If there is something that is considered market sensitive and the staff and the management agree, then it should be their call. If there is a dispute, it should be brought back to the Board. With those two minor exceptions, we are satisfied that there are no problems with the information.

Mr. Mirakhor said that the staff had covered the Board's view at the time of the FSSA discussion. It would be good if the request of Mr. Bernes and the Canadian authorities could be approved, but the March discussion was not far off, and the Board had agreed to wait for the result of the pilot project. Therefore, it would be good to wait, because the issue affected a number of other countries than Canada and there should be a chance to see what the staff would propose to the Board and discuss it in more detail. It might therefore be wiser to maintain the integrity of the agreement within the Board on the question of the FSSA.

Mr. Bernes said that the Board had not indicated in its October 1999 meeting that a decision should await the pilot project review at the end of March, although there could be different interpretations of that meeting. There were a range of issues to take into account. Perhaps the Board could come back to his request in a week or two.

The Acting Chairman said that he did not recall that the issue of the March review was so clear in the October discussion. There seemed to be disagreement on what had actually been said in the discussion vis-à-vis the publication of FSSA reports.

The staff representative from the Policy Development and Review Department said that the staff paper had suggested that the Board await the completion of the pilot program to determine the right balance between confidentiality and publication in the FSSA reports. However, that had not been among the issues presented to the Board for discussion in October 1999. Nevertheless, a number of Directors at that meeting had expressed a view on the matter.

Mr. Portugal agreed with Mr. Mirakhor that the Board should wait until its March discussion of the pilot project. The FSSA was a different process than the Article IV consultation, and the Article IV pilot project had been undertaken with the assumption that the FSSA report would not be published. Columbia, for example, had agreed to participate in the publication of the Article IV report but would not agree with the publication of its FSSA report, because it contained confidential information that should not be brought to the market. While Mr. Bernes had said that the case of Canada would not set a precedent, a decision to allow the publication of Canada's FSSA could discourage countries from participating in the Article IV pilot project and the FSSA, which were both voluntary.

Mr. Sobel suggested that the discussion be deferred for about a week. It was important to return to the issue soon, as Canada's FSSA report contained useful information that could help to strengthen the markets. The decision would not set a precedent, as the staff report referred to the FSSA, and Canada planned to publish that staff report. It therefore was critical for the Board to address the issue.

Mr. Shaalan agreed with Messrs. Milleron and Portugal. It was important to consider the credibility of the pilot project process, which had become increasingly tarnished. The publication of the FSSA report should therefore be delayed until the Board had its review.

Mr. Couillault said that in the previous discussion of the FSSA reports, the staff had said that it was working on a protocol regarding confidential material contained in them. It was important to have the staff's report before holding that discussion.

The staff representative from the Policy Development and Review Department, who was a member of the coordinating group between the Bank and the Fund regarding the FSAP pilot project, confirmed that there was a protocol being drawn up, looking into how confidential documents from authorities should be treated. That protocol was expected to be finished in the same time frame as the paper to review the experience under the FSAP, and would be part of the discussion on the issues related to confidentiality and publication.

The Acting Chairman said that there were clear differences of view concerning what the Board had discussed and what it decided at the past meeting concerning the FSSA process. While there was evidence that several Directors had concerns about publication, it was not known just how widespread those concerns were. The record should be checked. If there had been a clear consensus in favor of not publishing FSSAs until the conclusion of the pilot project, then the Board should wait until the discussion of the pilot project in March 2000. If not, then Mr. Bernes' request to take up the issue could be dealt with in a couple of weeks.

The Acting Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for maintaining sound macroeconomic and structural policies over most of the past decade, which had underpinned the strong performance of the Canadian economy, now in its eighth consecutive year of expansion. As a result of the Bank of Canada's successful inflation targeting policy, inflation had been maintained at a level among the lowest of the major industrial countries. Sharp improvements in federal and provincial fiscal balances had resulted in a decline in the ratio of government debt to GDP in recent years, and the prospects were good for further reductions over the medium term. Directors also noted that important structural reforms had been adopted, including improvements in the employment insurance system, the more complete financing of the public old-age support system, the continuing removal of barriers to inter-provincial trade, and a restructuring of provincial social assistance programs. Directors considered that these policy efforts had been reflected in a drop in the unemployment rate to its lowest level in two decades, low and stable inflation expectations, significant reductions in real and nominal interest rates, and a stable external position—with the external current account shifting toward surplus as commodity prices recovered.
>
> Directors noted that resource utilization had risen significantly in the last year, and that there is considerable uncertainty as to how much slack might remain in the economy. Although core inflation has so far remained well-contained, Directors considered that the rapid pace of growth raises the prospect that any remaining slack could be exhausted quite quickly. However, the authorities' success in maintaining low inflation had established the credibility of the inflation targeting regime, and Directors were of the view that this provided the Bank of Canada with some room to maneuver in testing the economy's productive limits. Nevertheless, Directors noted that it would be important to ensure that the limits of potential output were not approached

with undue speed, in order to minimize the risk of hitting capacity constraints before monetary policy could rein in excess demand pressures. They, therefore, welcomed the authorities' intention to respond promptly if signs of pressure on capacity or inflation should emerge, and noted that their pragmatic monitoring of a wide range of indicators should help in this assessment.

Directors supported the government's intention to use the prospective fiscal surpluses to continue bringing down the ratio of public debt to GDP, while also acting to reform the income tax system and to increase spending moderately in priority areas of health care and education. However, in striking the balance among these competing goals, Directors recommended that debt reduction and income tax reform should be the top priorities. Many Directors believed that it would be prudent to target somewhat larger surpluses now (especially in view of the presently favorable economic conditions (in order to better prepare for the longer-term fiscal cost of an aging population (especially in the area of health care). Some Directors were of the view that the authorities' debt reduction strategy, which envisages using any unspent portion of the contingency reserve to pay down debt, was appropriate—as Canada's debt-to-GDP position did not raise fundamental sustainability issues.

At the same time, Directors noted that reducing the high burden of personal and corporate income taxes offered considerable scope for economic efficiency gains. They, therefore, strongly supported the government's intention to introduce a multi-year plan to lower taxes and reduce tax distortions, while cautioning that the plan would need to be carefully phased so as to ensure its consistency with debt-reduction goals.

Directors noted that recent reforms in the Employment Insurance (EI) system were contributing to improved efficiency and flexibility of the labor market and to reducing structural unemployment. They welcomed the authorities' continuing commitment to these reforms in order to help the economy to operate at lower average levels of unemployment without triggering inflation. Furthermore, pointing to the still relatively high level of structural unemployment, a number of Directors believed that it would be appropriate to take additional steps to address remaining employment disincentives in the EI system. These Directors considered that phasing out the system of regional extended unemployment benefits would help to reduce disincentives to labor mobility. It was also suggested that tying the EI premiums for individual firms to the use of the system by their workers could yield additional improvements in the functioning of the labor market.

Directors commended the Canadian authorities on their demonstrated commitment to liberal trade through unilateral, regional, and multilateral initiatives. Nevertheless, they pointed out that Canada retained high rates of protection in certain sensitive sectors, such as agriculture and textiles and clothing. Directors encouraged the authorities to achieve greater liberalization in these areas in order to enhance the efficiency of the Canadian economy, as well as to improve economic prospects for many developing countries.

Directors welcomed Canada's participation in the pilot program of Financial System Stability Assessments. They noted that Canada's financial system was sound and stable, underpinned by strong balance sheets of banks and non-banks. Directors also noted that there was a high degree of compliance with the major international principles and standards on banking, insurance, and securities regulation and supervision, and on transparency and the payments system, and considered Canada to be a source of best international practice in a number of areas. Indeed, Directors considered that the Canadian authorities had gone beyond the international standards to address certain more complex risks in the financial system. As in other major industrial countries with advanced banking systems, ongoing innovations in financial markets and global competitive pressures would pose a number of challenges. Directors agreed that the Canadian authorities were already substantially addressing these challenges through their well-developed supervisory framework (with its emphasis on a consolidated, risk-centered approach). Nevertheless, they considered that the growing importance of the securities industry suggested that coordinating and harmonizing the regulatory framework for the industry at the provincial level would require increased attention.

Directors welcomed the Prime Minister's recent statement that the government intended to increase foreign aid in the next budget, and encouraged the authorities to move toward achieving their long-standing commitment to reach a development-assistance target of 0.7 percent of GNP.

Directors noted that the quality, coverage, periodicity, and timeliness of Canadian economic data were excellent both in the context of the Article IV consultation and for purposes of ongoing surveillance.

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

3. MEDIUM-TERM PLANNING OPTIONS AND RESOURCE ESTIMATES

The Executive Directors continued from Executive Board Meeting 00/4 (2/12/00) their consideration of a statement by the Managing Director on the medium-term plans and resource estimates (EBAP/99/149, 12/28/99), a paper on a supplementary budget request for FY 2000, which included an increase in the staff ceiling (EBAP/99/144, 12/23/99), together with a background memorandum by the Managing Director on the midyear review of the Fund's administrative and capital expenditures for FY 2000 (EBAP/99/145, 12/23/99). They also had before them a staff statement on further considerations relating to medium-term planning options and resource estimates (BUFF/00/14, 1/27/00), a background paper on medium-term plans and resource estimates—program outlook notes (EBAP/99/148, 12/28/99), a paper on medium-term plans and resource estimates—work program by department for FY 2001−FY 2003 (EBAP/99/151, 12/30/99), as well as a statement by the Managing Director on medium-term planning options (BUFF/00/4, 1/11/00).

The Acting Chairman submitted the following statement:

> The process of establishing a medium-term framework has been unusually difficult this year, as the Fund realizes the consequences in terms of human and financial resources of the important new or expanded responsibilities that have been placed on its shoulders. This process has been useful, even if the discussions in the Budget Committee and the full Board have been slightly animated. I hope that it has served to clarify the views of the members of the Board on the priorities attached to the various new initiatives.
>
> Management and the staff have taken account of the views expressed at the last Board meeting in January and have therefore included estimated savings and redeployment in order to show the full extent of an ongoing reallocation of resources to new priorities. I must say that I agreed reluctantly to that. Therefore, there is a new option between Options 2A and 2B, called Option 2A*, incorporating the expected savings from the internal review process, as well as a few of the savings on which the staff could later elaborate. The staff has responded to the requests to identify possible trade-offs in existing services to accommodate part of the new initiatives within existing resources and to shift some resources from the PRGF to technical assistance.
>
> I have been reluctant to propose a lower option than my preferred option, which I believe reflects the institution's needs, but it is important to reach a consensus. Nevertheless, I am concerned about several things. It is important not to cut too deeply into the proposed new activities because the Board has received a mandate from the membership, and cannot proceed half-heartedly or without the critical mass of resources to pursue these new initiatives. Further savings—in light of the current pressure on the staff, where there is no margin—could reduce the quality of certain essential Fund services. I am also concerned that there is no capacity within the resources estimates to undertake any unexpected, urgent task or to face a crisis that might come up.
>
> Directors are face with difficult choices. Many national public services have their own savings programs and have recently undergone severe cutbacks. However, our responsibility now is to provide the resources needed to face the task before the Fund. There is no room to further reduce the staffing requirements. Directors have seriously considered and reconsidered

the new alternative options; I hope that the Board can have a productive discussion.

Mr. Bernes made the following statement:

There is no easy answer; Directors face pressures here as well as from their authorities, and reconciling the two is not always easy. I appreciate the further work that the staff has undertaken, partly in response to the requests that I put forward last time. However, I am even further confused by some of the numbers presented. In Option 2A*, all of a sudden there are 16 person years available as a result of redeployment or savings elsewhere. Those years are not available under any of the other options, where they presumably should apply as well. Moreover, I do not understand how some numbers are traded between the PRGF and technical assistance. That leaves me with the question: Where are we, and what do we need to do? We need to reach a consensus in order to meet the essential requirements of the organization.

There are some problems with the medium-term process, which the Board, myself included, pushed management to adopt a few years ago when it was reluctant to take decisions on a one-year basis. The general principle of identifying medium-term implications is appropriate. However, given all of the uncertainties in terms of how some of the new initiatives will work over time, it is difficult to make decisions that are going to be binding over the medium term. I wanted to suggest, therefore, that the Board make a decision only on FY 2001, and keep the options open for the other years, given the level of uncertainty surrounding the initiatives and the preliminary results of the pilot projects. I am also concerned about the full resource implications of the initiatives in the absence of the report from the working group on stress. Furthermore, the Board has not yet discussed the external communications initiative, to which I attach a great deal of importance.

The lack of clarity as to how these numbers are put together and how they change underlines the need for a revised process in the future, and for an external evaluation of internal procedures, including a review of budgetary procedures. We are in the process of finalizing how that will be undertaken.

It is hard for the Board, and certainly for me, to micromanage and recommend, for instance, that 53 people should work on PRGF as opposed to 52 or 51 or 57 people. Those are the sorts of decisions that only management can take. Perhaps a better approach is to say that the Board is prepared to endorse a specific number of new hires and leave it to management to decide how best to distribute them, given the priorities that Directors have agreed upon and the demands. The only caveat I would put on that is with respect to increasing enhanced technical assistance; I would not like to see any lower number than that showing in the tables.

> We could choose Option 2A*, with an added factor for the external relations Department enhancements. That would amount to about 105 new hires. Management would could then decide internally on specific allocations, depending on how events unfold during the course of the year. Next year the Board could review matters and make decisions for the longer term, based on experience and the results of the evaluation of internal procedures. I wonder if such an approach would find favor and form a basis from which management could make an early decision about where the resources were and make decisions accordingly.

Mr. Shaalan asked whether Mr. Bernes' proposal was to add the extra positions required for the External Relations Department to the 98 new hires shown in the table.

Mr. Bernes replied that Mr. Shaalan's characterization of the proposal was correct.

The Acting Chairman wondered whether Mr. Bernes was suggesting that seven new positions be added to the External Relations Department.

Mr. Bernes said that he would leave the question of the exact numbers to management. He could justify to his authorities the need for 105 new hires for the Fund, in addition to the 30 positions that had already been approved, which would total 135 new staff, given the priorities that the Board had agreed upon. Management could then allocate those numbers appropriately, although the number of staff allocated to technical assistance was a minimum.

The Acting Chairman agreed that the number of staff to be made available for technical assistance was a minimum. He took not of Mr. Bernes' suggestions in terms of revision of the process and external evaluation.

Mr. Portugal asked how Mr. Bernes had arrived at the number of 105 new hires, in light of his view that adding up the figures for the various programs would mean that the Board was micro-managing. Deciding priorities in the budget process should not be considered micro-management; it was the legitimate function of any budget process to allocate scarce resources among different, competing aims.

Mr. Bernes replied that the Board should not make a precise judgment on individual staffing levels, but rather establish priorities. A normal budgetary process started with identification of the resources that could be made available. Based upon the arguments of the staff and the views expressed by the Board, the range in terms of what might prove acceptable was wide, amounting to between 84 and 153 staff members. The figure of 105 new hires was likely to be acceptable to Mr. Bernes' authorities, as well as to the Board. It came close to Option 2A, which provided additional resources for external relations—although not as many as Mr. Bernes considered necessary. The lesser option did not provide all of the resources that had been initially requested.

Mr. Taylor asked what 105 new staff members would cost. What percentage increase in expenditure would that amount to, and how would that compare with the expected change in the revenue and profit of the organization? It was difficult to suggest an adequate staffing level without micromanaging certain numbers. There were some outside realities that any public sector institution with its own resources needed to take into account.

The Director of the Office of Budget and Planning said that 105 new staff could be interpolated to cost $27 million for the first year, which included the impact of the supplementary budget. That included an estimated half of the needed salaries—because not all of the positions were likely to be filled by May 7—and all of the overhead costs, including building occupancy, so it was an all-inclusive figure.

Ms. Lissakers asked what the additional $27 million represented in terms of the combined percentage increase as compared to the previous fiscal year's budget.

Mr. Yoshimura made the following statement:

> I thank the staff and management for their efforts in drawing up the new Option 2*, which reduces the number of staff by 16. I support this option, although there are a few comments that I would like to make.
>
> At several meetings it has been suggested that the Fund should try to improve the effectiveness and the efficiency of its work. Last year, few Directors, including myself, suggested several staff-saving measures in the joint statement on the FY 2000 budget. It is good to see that one of these suggestions—the review of the Fund's internal review process—has been adopted. However, it is regrettable that other suggestions in the statement have so far not been taken up. I urge management to implement periodic reviews on the streamlining and rationalization of activities in order to find a solution.
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> In this regard, I welcome management's commitment that the OIA will implement an overview of the departmental, and interdepartmental, work. However, questions about the objectivity of OIA reviews remain. The statement by the ten Executive Directors that I mentioned earlier also proposed an external evaluation of the Fund's internal procedures. This measure has to be implemented if the Board is to meet its responsibility for the budget while avoiding micromanagement. I would appreciate it if management would give us its views on this issue. If we cannot find a way to improve the internal budget procedure, there may be no choice but to automatically cut a number of positions each year in order to promote the deployment of the staff and prioritize the Fund's work more effectively.
>
> On the PRGF/PRSP initiative, it was agreed that the Fund should not step into work aimed at poverty reduction and structural reform of the private sector. I understand that under this initiative, the Fund needs to increase its

work related to the macroeconomic framework. This is a new role for the Fund, to examine what kind of macroeconomic framework would help or at least not hinder poverty reduction. However, in the interim PRSP for Bolivia, for example, which the Board will discuss this coming Friday, I see little theoretical and political analysis on the link between macroeconomic framework and poverty, such as the relationship between output growth and poverty or between the possible trade-off between fiscal consolidation and increased social spending. This is a beginning, thus, pending further analysis on the linkage between macroeconomic framework and poverty in the future PRGF program, I can support management's proposal for a staff increase in this area. However, I would also propose that we review the medium-term plans and the resource estimates for the PRGF/PRSP initiatives in FY 2001 when we have more experience.

In-house technical assistance will be helpful to the PRGF and other initiatives. As Japan is the largest contributor to the Fund's externally financed technical assistance, we will pay careful attention to how the Fund's technical assistance is monitored, evaluated and assessed. Compared with the monitoring and evaluation systems of other organizations, the Fund's current system leaves much to be desired and it will take much work to bring it up to par. I support increasing resources for this purpose.

I welcome the initiative to improve external communications, and have for some time emphasized the importance of external communications strategies. I share the staff's view that a number of staff would have to be added if the Board agrees to that initiative.

Mr. Donecker made the following statement:

The medium-term staff resource needs are still unclear, with several important pilot projects underway, thus the Board will need to come back to the staffing needs for 2000 and beyond at a later stage. We will reserve our position on those issues until then.

The Board has discussed staffing needs for FY 2001 at length. I am grateful to the staff for presenting alternative options that include expected savings from the internal review process and further savings of 16 staff positions. I would have preferred to discuss needs in a comprehensive way, together with the communications initiative and the report on stress which regrettably has not yet been made available. We should try to come to a decision today on the staffing needs for FY 2001.

Looking at the figures in Tables 1 and 2 of the most recent staff statement, and keeping in mind the Board's previous discussion on the matter, I feel that Option 2A* could be supported by everybody. Certainly no Directors will be completely happy. We, for instance, would have preferred a different outcome, but we need to find a compromise that has the desired broad-based support. We are therefore willing to accept Option 2A* if it finds broad consent.

I would like to finalize the staffing needs issue today, but also set the ceiling for all staff positions, including the external communications initiatives for FY 2001. For now I am willing to listen to what my colleagues say, but I have much sympathy for Mr. Bernes' proposal of setting a ceiling of 105 new hires.

Mr. Barro Chambrier pointed out that Mr. Bernes appeared to be supporting Option 2A*. The only difference was that he had added seven staff positions for the communications initiative.

Mr. Bernes responded that it was up to management to decide whether additional staff would be devoted to external communications. Option 2A* with a slight increase of seven staff would bring the net number of 105 new hires. Within that allocation, the only minimum staffing level that needed to be established would be for technical assistance.

Mr. Barro Chambrier said that meant there could be more than seven people allocated to external communications, but the Board did not have all of the background necessary for the discussion on the needs of the External Relations Department.

The Acting Chairman replied that it was understandable that Mr. Barro Chambrier wanted to hear more about what was planned for external relations, but first the Board needed to decide whether Option 2A* was considered appropriate, insufficient, or excessive.

Mr. Barro Chambrier said that the staff had worked hard to refine the different options, and the Board now had a clearer view of what was involved in the different initiatives. His preference was for Option 2, but he could support Option 2A* if there was a consensus, because whatever scenario was agreed on the PRGF and the enhanced initiative, it would be a minimum. It was difficult to include external communication at that stage of the discussion, thus Option 2A* was the limit.

Mr. Cippà disagreed with Mr. Barro Chambrier. The options currently before the Board were exactly the same as during the previous discussion. The only difference was that there were now 16 staff members to redeploy, but Mr. Bernes had mentioned that this factor applied only to Option 2A. It would have been better to apply the savings to all of the options. During the Board's previous discussion, a strong majority was more inclined toward Option 2A and not to Option 2A*. A compromise should be made between the two options, which would mean moving away from both sides.

The Acting Chairman noted that management's initial proposal had also been revised. It was not fair to ask management to compromise between its current offer and another one. He would not encourage his colleagues in management to accept one less staff member than proposed. Compromise was always possible, but the staff had been mandated to perform a clear analysis of the Fund's needs and it was time for the Board to vote.

Mr. Bauche made the following statement:

> This budget process has been unusually animated. Since last November, the staff has produced about 250 pages on this issue, and this is our second Board meeting on the subject following a number of committee meetings. Much time and energy have been spent on this issue, and I hope that we will come to a consensus today.
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> We have repeatedly expressed our preference for Option 1. This option remains the key to enabling the Fund to implement major initiatives, while at the same time maintaining efficiency and respecting constraints. The Fund must be cost-driven but, equally, reform-driven, which means that budgetary considerations must not be allowed to threaten the impetus for reforming the international monetary and financial system or jeopardize surveillance. The reform of the monetary and financial system must be taken as a whole, and the new initiatives must remain integrated as such. But it is time now to reach a compromise. I welcome the staff's efforts, through Option 2A*, to address the concerns expressed during the last Board meeting in terms of new internal savings and deployment in important areas such as technical assistance.
>
> Directors may still disagree on figures, but it is in our common interest to help the staff, which is our primary resource in accommodating the new challenges of an ever-changing world. Consequently, we must not prolong this bargaining session where each of us, according to our own individual preferences, picks and chooses from the "shopping list" of the new initiatives. In this spirit of compromise, I support Option 2A*.

Ms. Lissakers made the following statement:

> The staff did not do what Mr. Bernes and I specifically asked, which was that the reduced numbers proposed under Option 2B be taken out of existing activities so that the Board could have the full array of trade-offs before it when considering staffing needs. It would have been useful to have had at the beginning, rather than at the end, of this lengthy process, a presentation showing that in order to implement certain initiatives, certain research or missions would have had to be cut back. It would have been reasonable to present those choices. Option 2A* does provide a savings of 16 staff members, which apparently only applies under Option 2A. Why that disappears under Option 2B is puzzling, as others have noted. It suggests, again, that the staff was simply not inclined to give Option 2B a fair presentation, and I am not happy about that, although that is not new in the Fund's budget process.

The proposed trade-offs within the so-called new initiatives are questionable. The overall distribution of going back to the original proposals and those that the Board continues to be presented with turns the hierarchy of priorities on its head. The Fund should concentrate more intensively than it has in the past on financial crisis prevention and the assessment of vulnerabilities and market-driven disruptions. That means devoting maximum resources to the financial sector, standards and codes, and enhanced surveillance, particularly of vulnerabilities and market assessment.

The World Bank is the lead agency and the institution that carries the larger burden of the new elements of both the HIPC Initiative and the PRGF. The macroeconomic elements are not new; the Fund has been responsible for them in the past. The Bank and the countries themselves should share the burden of carrying this new initiative forward in terms of poverty reduction and social elements. The Fund should be prepared to provide more technical assistance to support both the PRGF and the other initiative standards and codes and financial sector data. However, the distribution proposed under Option 2B is nonsensical and does not show a good faith effort to respond to the Board's views in this area.

I remain resistant to the notion of devoting so many new staff positions to the PRGF and the HIPC Initiative. Many of us had agreed that some additional work would be needed to push so many HIPC Initiative cases through in a short period, but that would then taper off. Nevertheless, the staff has proposed that the number of staff devoted to PRGF and the HIPC Initiative increase in the coming years. Those numbers should decrease, it would seem, if the right work is being done and the division of labor between the Bank and the Fund is adhered to. Thus, I am not satisfied with the proposed distribution or the total numbers. Option 2B would appear appropriate, with a good-faith effort at redeployment. The huge commitment of personnel proposed for PRGF should provide room to take care of what we should be taken care of, including external communications, which also requires attention and increased effort.

I, like others, find the planning and budget process puzzling and unsatisfactory. I do not know of any other institution that makes decisions or near decisions on hiring without any reference to cost. How can this be seriously discussed without a dollar number? I await, with interest, the figure that the staff will come forward with on this, but I do not think it is something we will be able to defend in our member countries. I therefore strongly join the others who have called for an external review of budgetary processes and procedures.

Given the uncertainties and the fact that the preparatory work has not been completed, we should put "No Answer" in the outer years column in the medium-term planning process, because it is impossible to even hazard a reasonable guess at this point.

The Acting Chairman stated that Ms. Lissakers was oversimplifying the choices regarding the distribution of responsibilities between the Bank and the Fund. The Executive Board had been clear that the Bank must take the lead on the issues, while the Fund would obtain from the Bank all of the material necessary for its own work, not only for the HIPC Initiative but also for poverty reduction and growth strategies. But there were two elements of the new initiatives that would be costly in terms of human resources for the Fund. One was the effort needed to reach out to civil society, which could require an enormous effort from the staff and a strengthening of human resources. The Bank, which was much better placed than the Fund with respect to public relations, would be asked to take that in hand. However, the Fund would also have to be involved, albeit with more limited means, in order to discharge its new responsibilities.

Despite the division of labor between the Bank and the Fund, additional resources were needed for the much more ambitious and complex programs, the Acting Chairman continued. Although the Bank would take the lead in poverty reduction, it would nevertheless require a major additional effort from the Fund in the definition of macroeconomic programs. The contact with civil society would also require resources. It was difficult to say how much that would mean, but it would be fair for the Board to factor that into its reasoning.

Ms. Lissakers said that while public outreach was important, the most important public outreach needed to come from the governments themselves. In the recent intense debate about Uganda, for example, management, the staff, and Mr. Morais had highlighted the outreach efforts of the Ugandan authorities under the enhanced HIPC Initiative. Uganda had also put together a poverty reduction program, with the necessary outreach, apparently without a massive increase in Fund support. It had succeeded because it owned its poverty reduction program. That was the ideal situation. There was no need for larger armies of Bank and Fund staff taking charge of the process. Instead, the country needed to do the work, and to the extent that more resources were required for analysis the responsibility should rest primarily with the Bank, with some addition to the Fund.

The larger staff numbers were a concern not only in terms of the Fund’s budget resources and costs, but also with respect to where the Fund was headed, Ms. Lissakers commented. Was the Fund creating an expanded international program, rather than a better domestic policy process in the countries it was trying to help? The second point was the desired outcome, not the first, at least in terms of the HIPC Initiative.

The Acting Chairman pointed out that an immense effort had been put into Uganda over a long period, and the country was now at the point where the government owned the program, did the work, and conducted the dialogue with civil society. That was the point that the Fund wanted to reach with other countries, but it would take some time and many countries did not have the necessary resources. Thus some external assistance would be necessary.

Mr. Mirakhor made the following statement:

> The staff have made considerable efforts. They indicate on page 5 of their report that resource estimates for the PRGF have been derived on the basis that poverty assessments will be carried out by the World Bank, which will be a full partner in the implementation of this facility. The Fund will not undertake any social-sector work as it will remain the responsibility of the Bank. Then, the staff give seven reasons why additional staff are still needed in order for the fund to be involved in the PRGF. I would like to ask Ms. Lissakers, which one of these reasons she considers invalid.
>
> I do not understand the notion behind an army of Fund staff visiting these countries; the staff are asking for less than one staff member per country. While it is important to be reasonable about the demands for resources, we have to remember that there are six new initiatives. Directors arguing for cutbacks in resources are the same ones who pushed hard for these initiatives and convinced other Directors to support them.
>
> I agree with Mr. Bernes that the Board needs an external evaluation of internal process. That would show how absurd it is for management and the staff to have to bargain for the staff to carry out the initiatives requested by the Board.

The Acting Chairman said that the point should be in the terms of reference of the external evaluators.

Ms. Lissakers stressed that no one was arguing for cutbacks. Even under Option 2B, there would be an additional 130 staff for all of the initiatives. That was a huge increase in staffing, and the Fund was not likely to be able to constructively absorb 130 new staff in one year.

Mr. Mirakhor reminded Ms. Lissakers that Option 2B involved major cutbacks in the technical assistance and surveillance efforts associated with the new initiatives. The Fund's main functions were surveillance and technical assistance training; if Option 2B were chosen, those traditional services would be sacrificed. The trade-offs were clear in the staff report presented on January 27, 2000.

Mr. Rustomjee made the following statement:

> Regarding the case of Uganda, my colleagues will recall that we were quite vociferous in our comments on the operational modalities of the PRGF and PRSP. One of the points we made during that discussion was we believe that in placing poverty directly in the scope of the Fund's work with PRGF countries, the magnitudes involved would be substantial. We continue to believe that. That is coming out now in the discussion of the budget, and it will become clearer as individual country cases are looked at. Uganda has

been cited, but probably every one of the HIPC Initiative cases would raise the same issues.

I do not agree with any of the views expressed on the options. Even Option 1, establishing 56 new staff positions in the first year is a gross underestimate of what the Fund would need simply to effectively introduce the linkage between poverty and macroeconomic stability. That is a huge challenge for the countries concerned. The countries we represent would like to go well beyond ESAF and integrate poverty work into the overall objectives in moving towards more sustainable growth. The Fund's role will thus be enormous. Three or four staff people per HIPC or PRGF country would be required to help those countries integrate poverty work, for example, with medium-term budgeting and a whole range of other areas. Clearly the Fund does not have the necessary staff.

Thus, I disagree with Ms. Lissakers. In my view, we might need much more than the staff has foreseen under Option 1. I also disagree with Mr. Mirakhor, because having less than one additional staff member per country makes no sense whatsoever if the Fund is to seriously place poverty reduction at the center of its work in low-income countries.

The question is where do we begin. Do we start by bolstering the resources of the institution, which makes a great deal of sense? Here I share Mr. Mirakhor's view that if we place responsibility on the staff, we cannot shy away from allocating the appropriate resources for the staff to deal with the associated responsibilities. There is thus a good case to be made for bolstering the institution's resources by substantially more than presented. On the other hand, we could take the issue of making the programs owned by the countries more seriously by allocating resources to the countries concerned. There is an equally credible and legitimate claim to allocate all of the 56 new staff members to enhanced technical assistance. The countries would then decide how they would use the resources.

I do not say this glibly, but because the resource needs are enormous. If they were not, the poverty in these countries would have been resolved years ago. I have a grim recognition that some of the things that we said when we intervened on the operational modalities are already starting to play themselves out.

Mr. Barro Chambrier commented that Ms. Lissakers' position was surprising, because she had been one of the most prominent figures advocating the initiatives. She was right regarding surveillance and the financial sector, but not on the PRSP, the PRGF, and the enhanced HIPC Initiatives.

According to the African Department, the current staffing was insufficient to conduct missions in countries, and there was already a lag, Mr. Barro Chambrier reported. To that would be added the PRSP, the PRGF, and the enhanced HIPC Initiative, because in countries such as Senegal, Benin, and Chad there was a need for a separate mission to assess the PRGF and the enhanced HIPC Initiative. People with skills were needed. That was adding to the existing staff's burden.

It could not be said, as Ms. Lissakers had suggested, that the macroeconomic framework of the PRGF was similar to that of the ESAF, Mr. Barro Chambrier commented. During the IMFC meetings, the Fund had committed itself and it could not now take a step backward, which would be difficult to explain. The Fund needed staffing to accomplish its mission.

Ms. Lissakers said that she agreed with everything that Mr. Barro Chambrier had said, except for his conclusion in terms of staffing needs. The change from ESAF to PRGF and the HIPC Initiative enhancement were intended to change the way that governments and Fund missions approached and focused their work. They were not intended to be an add-on, but a change in the way that the Fund thought about the countries' problems and designed policies. That did not necessarily lead to need for an additional team to do the work. Some resources would be needed at least in the near term during the intense HIPC Initiative phase.

It would be perfectly consistent with the Fund's new vision, as Mr. Rustomjee had suggested, if rather than having larger missions the Fund made resources available for technical assistance that countries could draw on as needed for specific problems, Ms. Lissakers commented. That was one reason why the deployments represented under Option 2 were disingenuous. There was scope for moving staff in the outer years and even in the first year from the PRGF designation to technical assistance. That would be consistent with the Fund's redesign and responsive to the needs of PRGF members.

Mr. Shaalan said that he associated himself with Ms. Lissakers' remarks regarding the PRGF and PRSPs. He did not wish to see the number of countries eligible for the poverty reduction exercise decreased from 57 to 54. There was a problem with paragraph 9 of the staff report, in which the staff reiterated the position that the Fund would not undertake any social-sector work. However, it went on to say that: "Even though countries will be responsible for preparing the PRSPs, substantial effort will be required of staff to establish appropriate linkages between policy, outcomes, and instruments." That suggested the Fund would be going further into the social sector. Work on specific policy outcomes and poverty reduction had to be carried out by the World Bank. It appeared that the increase in the staff's work involved increased work on social issues. That raised difficulties not so much with respect to the magnitude of the request but in relation to excessive involvement of the Fund staff in social issues.

Mr. Taylor agreed with Mr. Rustomjee's views. The PRGF/PRSP exercise was enormously staff-intensive, if carried out properly. However, did Mr. Rustomjee not see it as being more than a partnership between the Fund, the Bank, and the country? Would he see all other relevant agencies concerned, both multilateral and bilateral, where relevant, drawn in? That would be desirable because in particular situations they might achieve better results.

Mr. Donecker said that he agreed in principle with Ms. Lissakers and Mr. Shaalan on the issue of the PRGF staffing needs, although it was important to be aware that the Fund had been asked by the Interim Committee for an upfront effort in that area. Thus, for at least six months, the Fund needed to devote resources to that, and needed to hire new people who were especially qualified for that kind of work. That was why he was supporting the staffing needs under Option 2A* for the PRGF.

Mr. Shaalan clarified that he was not proposing cutting staff for the PRGF. The Interim Committee had decided to proceed quickly in that area. However, the social work had to be done by the Bank and not the Fund.

Mr. Bauche agreed with Mr. Donecker. The Fund would not be undertaking the social work, and the workload could be expected to decrease over time, but the numbers initially needed to be commensurate with Option 2A*.

Mr. Wijnholds said that the discussion could go on endlessly, but it was difficult to put a precise number forward. While Mr. Bernes' number might not be the most appropriate, his approach of leaving to management the exact distribution of the additional staff was right.

Mr. Collins made the following statement:

> I echo Mr. Wijnholds' sentiment. While the PRGF requires one extra person per country, that is not all that will be involved. ESAFs have an average of seven staff per arrangement. The new eighth person will not do all of the social outreach while the other seven carry on as before. Instead, they will have to refocus their activities; that is the point of all of these new initiatives. The PRGF is a microcosm of what the Fund is trying to do generally, which is to reorient itself in certain directions. That means doing more of one thing and less of another. At the end of the day, the least important activity must be dropped to make the way for a new, more important one. That is a kind of a marginal operation, which management is better placed to do than the Board. It is the job of the Board to set the orientation and priorities and to provide reasonable resources to do it. We have to trim our resources and push the organization to refocus by providing incentives. These incentives can include setting the direction and restraining the budget so that decisions are made about priorities, in light of that the Fund would like to do and the international community would like it to do.
>
> This comes down therefore to a discussion about what the appropriate number is. Mr. Wijnholds' number is lower than Mr. Bernes'. The Board will have to agree on a number, however it is built up. We cannot tell how the world is going to evolve in the next year, so management will undoubtedly juggle the resources it has. Whatever agreement is made, even if it conforms with Option 2A* exactly, in a year's time there will not be 57 people working on PRGFs, for example, because other things are happening. If there could be

agreement on a significant increase in staff numbers, then management would have a free hand as to how to meet its responsibilities.

Mr. Yoshimura noted that everyone agreed that the social work of the HIPC Initiative and PRGF should be done by the Bank and not the Fund, although there was still additional work to be done in relation to the new initiative in the macroeconomic area. It would be helpful to know exactly how many additional people were necessary. Directors had to give management the benefit of the doubt. Then the numbers could be reviewed after about one year.

Mr. Cippà agreed with Mr. Bernes' approach that the Board should come up with a number. The figure proposed by Mr. Wijnholds, which was slightly lower than Mr. Bernes' suggestion, appeared to be appropriate.

The Acting Chairman asked the Director of the Policy Development and Review Department to summarize the Board's previous discussion on the operational aspects of the HIPC Initiative and PRGF.

The Director of the Policy Development and Review Department commented that to a certain extent the Board was trapped in language on some issues. One trap was the presentation of the additional needs for PRGF and the HIPC Initiative. The presentation seemed to assure that the previous position was optional and some additional responsibilities had been added. That was simply not the case. If no enhancement of the HIPC Initiative and no transformation of the ESAF into the PRGF had taken place, there would still have been a need for more staff. Neither PDR or the African Department had enough staff to cover missions. The staff could not continue to move from country to country undertaking missions in sequence and still dedicate the necessary time and effort to each country. More resident representatives were needed. Another issue was the enhancement of the HIPC Initiative and the intention to accelerate implementation. It was clear that an additional effort needed to be expended.

Another area of difficulty was technical assistance, the Director noted. A clear line did not exist between a staff member who provided technical assistance and one who worked on ESAF/HIPC Initiative countries in the context of regular missions. A good deal of the time spent on regular missions, both Article IV consultation and program missions, involved technical assistance. In such cases the staff often worked with the staff of the country's Central Bank, in the treasury, and elsewhere. Then the staff had to stop the direct-line process of negotiating a program and pursue another direction, because a technical issue came up that had to be resolved on a range of developments such as accounting for various budget, or on the best way to deal with tax issues. That happened on a regular basis. Thus, it had to be recognized that a fairly large gray area of overlap existed between mission work and technical assistance work.

It was not clear how Mr. Shaalan arrived at the figure of 30 percent, the Director stated. It was the staff's intention to leave the work on social issues to the Bank. In the past, the Fund had been criticized for framing macroeconomic programs with countries without taking into account what the Bank and other donors were doing, for excessively tight macroeconomic policies when aid was offered, and for not allowing aid to flow to those countries under the agreed framework. One of the intentions of the PRSP was to bring the operations of all major players together in order to deal with those kinds of issues, an iterative process in framing the macroeconomic policies of the country necessary. The Fund would have to be informed on an ongoing basis, and not simply have the Bank provide a list of projects. But the Bank had to be part of the process that developed the macroeconomic framework, including the investment program and the anti-poverty program.

The Fund could not stand back from the participatory process, the Director commented. Ms. Lissakers was correct that there had been a shift intended to promote the framing of the government's policies in a consultative process, which would involve donor agencies, civil society, and NGOs. Ideas, policy proposals, and suggestions that the Board would not support could be expected to arise in that context. Protectionism was rife in the countries concerned; when NGOs in countries were consulted, they could seek a good deal of protectionism. It was, therefore, to see how the Fund staff could disconnect itself from that process. If the Fund staff was not part of that discussion, poverty reduction and strategy papers that the Board could not support might come before it.

The Fund would also have to be part of the dialogue on civil service reform and other changes in countries, the Director continued. That did not mean that the Fund staff would lead the participatory process, but that it had to be involved sufficiently by the process to help steer results in a direction that the Fund Board and the Bank Board would be willing to support. This role went to the issue of ownership. It was difficult to foster ownership if the two Boards conducted their fiduciary responsibilities to approve only lending programs that contained policies they believed would better the situation. Thus, considerable interchange was required amongst the Bank staff, the Fund staff, the country authorities, and civil society if the consultative process was going to be properly pushed forward.

Mr. Mirakhor made the following statement:

> Let me thank you and the staff for the additional work that went into preparing the January 27th statement, and also for putting on the table the new proposal under 2A*.
>
> As you know, we did not support Option 2A and see no compelling argument to support Option 2A*. But, reluctantly, we join a consensus in support of Option 2A*, and I do so, like Mr. Donecker and Mr. Bauche, because I believe it would be irresponsible to continue delaying a final decision on the budget. We need to move forward, if for no other reason than the expectations that the new initiatives have created among the membership. And I do so because if there were to be no further strain on the staff in traditional functions we perform, the initial proposal of the MD was a gross underestimate. If you recall, I gave approximately ten reasons in the Committee meeting as to why I thought it was an underestimate. Since I am certain that the staff will do their best to carry out the new tasks, I know that

once again they will bear the brunt of the cost of lower level of resources contained in Option 2A* through increased workload and increased stress.

In addition to the reservations I already expressed in the last meeting regarding alternative Option 2A, I would like to state two concerns I have about Option 2A*. First, the withdrawal of 16 staff from the review process, which is of enormous concern to us. This process is perhaps the most important element of the internal quality control mechanism that has served this institution and its membership as well. Our concern was heightened, even before the number of cutback, when staff expressed concerns about the fact that an erosion of technical oversight has been exacerbated by cutbacks in recent years due to resource limitation.

It is, therefore, counterintuitive to me that the 2A* proposal would have no adverse impact on quality control. Given the enormous value we all place on programs' success and on surveillance, I am certain that proper assessment of the value of the review process would well justify the required costs without any additional cutback.

My second concern relates to the proposed cutback of additional staff from 15 to 10 in Option 2A* in the area of enhanced surveillance. The trade-offs here are stated in paragraph 19 of statement 00/14 of January 27. Recalling that enhanced surveillance is an important element in the constellation of Fund's crisis prevention measures; it is unfortunate to reduce the modest level of resources that could allow more rapid strengthening of various dimensions of this element.

So, I would urge management to think about the possibility of not cutting back on this particularly important area.

The Acting Chairman noted that Mr. Mirakhor had expressed concern about the possibility that quality control might be compromised if cuts were made to the number of staff engaged in the internal review process. Management also had concerns in that regard. That review was ongoing, but the intention was to rationalize the number of departments involved in mandatory and formal review of country, policy, or other staff reports and documents. Such measures would entail steps to improve quality control in the department responsible for the preparation of the paper itself, and there would be steps to encourage more informal consultation and less formal paper to deepen the review work. Management intended to pursue those possibilities without compromising advice to the membership and essential due-diligence functions carried out by the review departments. Thus, the 16 fewer positions would not come solely from the review of the internal review process, but would also be saved out of those efforts.

Mr. Shaalan said that the one-third of staffing that he had estimated for the poverty reduction program was probably associated with social-sector activities. Was that roughly the number included in the request for 53 staff?

The Director of the Office of Budget and Planning responded that a graph prepared for the program outlook note for the PRGF showed that the World Bank was currently devoting about 850 staff members to such social work, while the Fund had been devoting about 200 people to ESAF. It also showed what the Fund and the Bank were proposing to add. The staff had tried to make a distinction between the part of that increment that would be devoted to enhancing the HIPC Initiative work and the part that would go to changing the ESAF into the PRGF. That was difficult because all programs were now supposed to have a social component, which was typical of the poverty reduction strategy. Nevertheless, making a broad estimate for the first year—taking into account that the number of HIPC Initiative countries was to increase and that about 12 countries that had had a HIPC Initiative program in the last two years were to be revisited in the first year—about two-thirds of the increment would be related to debt relief and one third would be related to cooperation with the World Bank in social-sector work.

Mr. Portugal made the following statement:

> I would like to thank management and the staff for the effort in providing additional information and putting together a new proposal to respond to the Board discussion on January 12. At that time, I said that I would be prepared to support a revised version of Option 2A that would attribute higher allocations for technical assistance, an important issue for countries in my constituency. I was also concerned about how to incorporate what the Board decided with respect to external relations into the total figure indicated for Option 2A.
>
> Option 2A* takes into account most of our comments. There is an increase in the number of staff allocated to technical assistance. Management has indicated that it expects savings of 16 staff from the internal review process and other changes, which would accommodate whatever staff is allocated to external relations, and not make the total higher than the original figure for Option 2A. My understanding is that the achievement of saving of 16 staff is a firm commitment that management is undertaking to the Board. With that understanding, I am prepared to support Option 2A*.
>
> I am not inclined to agree with Mr. Bernes's suggestion that the Board establish an overall number and leave it to management to decide on the allocation. First, it is not too clear how the number of 105 or any other number came about. Mr. Bernes said in reply to my question that this is a number that the authorities in his constituency would accept. But what is the rationale for it? Second, I do not agree that deciding on the allocation of scarce resources to competing aims within a budget process is micromanagement. It is the legitimate function of any budget process to decide not only where the budget constraint will be and what the total amount of resource will be, but also how the money will be allocated. I do however agree with Mr. Bernes and others who said that the Board should make a final decision only with respect to 2001, and come back to discuss other years later.

Regarding the discussion that took place on whether it is possible to reduce the staff numbers allocated to the HIPC Initiative and the PRGF, my position would be similar to that of Messrs. Rustomjee and Shaalan. The Fund should not get directly involved in poverty issues and the preparation of PRSPs, nor in the consultative process. The Fund participation in this consultative process would not substantially change the outcome, as compared with intervening at a later stage by simply analyzing the outcome of the process. The fact is that the Fund and the World Bank Boards have decided on this. I would not like to see countries that are candidates for the HIPC Initiative or the PRGF suffer adverse effects, as Mr. Shaalan said, because of the cut. Thus, although I am in favor of a smaller number, it depends on how that number is going to be achieved, which is why it is not possible to simply decide on a number, without discussing the question of how the money is going to be distributed. If the Board needs to come to a consensus today, then there are other alternatives to be considered.

I repeat that while I favor increasing funding for financial stability assessments, as it is part of our mandate, that is different from saying that we have to do everything at once. To foresee 23 new financial stability assessments in the next fiscal year, which is assumed in all options, is perhaps an overestimation, especially as the policy still has to be finalized. Only four pilot assessments have been completed, and there are eight to go. Even if all of the new staff years were approved, it will be difficult to complete an additional 23 assessments from now until the end of FY 2001. Thus, there could be some phasing, if necessary, to achieve consensus here. However, the addition of staff in any area or activity that is still pending a final decision by the Board should be considered a conditional decision, which does not preclude what the Board eventually decides.

I am also in favor of the proposal to attach a dollar amount to the budget to facilitate discussions.

The Acting Chairman said that the saving of 16 staff was a firm figure.

Mr. Barro Chambrier made the following statement:

We would like to commend the Office of Budget and Planning (OBP) for the tremendous work it has performed in refining the different options presented for decision.

On the new Programs and Initiatives, it should be reminded that the decision to implement them reflects “the course of action mandated by the Executive Board and urged by the Interim Committee” (EB/CB/99/6, page 5). Accordingly, we view these highly publicized new programs as a commitment on the part of the Fund. The idea of spreading the programs over time in order to limit their annual cost is not a bad one, but for the already launched PRSP, PRGF and Enhanced HIPC Programs, any further delay in allocating adequate human resource may jeopardize their success. Moreover, PRGF and enhanced HIPC Initiative should be considered from a long-term perspective, and in this regard, the required additional resources for their implementation need to be planned for the medium term, even though annual reviews can be envisaged for evaluation purposes.

In addition, as repeatedly mentioned by PDR and African Department, and as Mr. Boorman eloquently reminded us today, present staffing resources are insufficient to enable them to adequately conduct missions in countries. Consequently, we would like to draw the attention to the fact that the lack of adequate human resources for the Fund may penalize some countries in their dialogue with this institution and delay the process of poverty reduction. We also believe that Technical Assistance should be enhanced, even if almost all the programs encompass a technical assistance dimension.

Considering the already high level of work pressure facing the staff, it is our view that much should not be expected from further redeployment or reviews of existing activities. Any added workload without adequate additional means would negatively impact the staff's health and the quality of its work.

Turning now to the different options, at the outset, we reject Option 2b, that purely eliminates activities like assistance to post-conflict regions. As we cannot prejudge at this moment the savings deriving from the internal review process, we also remain cautious about Option 2a*. Option 2a would be a better choice, although we disagree with the idea of simply cutting out the planned enhancement of Media and Public Relations. As a result, in order to join the consensus that is taking shape, we are reluctantly willing to go along with Option 2A*.

Mr. Al-Turki made the following statement:

Let me first thank staff for the additional work done on the medium-term staffing needs and hope that these efforts will facilitate reaching an agreement today. Let me also add here that while an iterative process may be necessary to achieve consensus, it would have been more productive if this process had taken place in the Budget Committee.

In the spirit of compromise, I can support Option 2a* as it strikes a good balance, in my judgment, between the need to maintain a tight ship while undertaking a number of new initiatives. In this regard, I welcome the additional expected savings of 16 staff years in FY 2001 resulting largely from the planned streamlining of the review process. I also look forward to further savings as a result of the planned reviews of internal work practices and organization of area and functional departments.

Mr. Cippà made the following statement:

I support setting a net staff increase along the lines proposed by Mr. Bernes, with the same justification. As to the exact size of the staff increase, I favor the suggestion of Mr. Wijnholds. The decision that the Board takes should only cover FY 2001, and future years should be discussed later. The Board should also start without delay the review of the budgetary procedures.

Mr. Schlitzer made the following statement:

Let me join other directors in thanking the staff for taking into account some of the comments expressed by Executive Directors at the last Board meeting.

Option 2A* is acceptable to us. We note that it achieves further savings through a minor reshuffle of resources and feel that the Fund's capacity to deliver on its priority areas will not be restrained. However, I cannot agree with Directors who have proposed agreeing on an aggregate number without considering the precise allocations. In this regard, I fully support Mr. Portugal's views. Our preference for Option 2A* is not just for the aggregate number, but for the allocation of resources among the different practices. In particular, we welcome the increase in resources for technical assistance envisaged under Option 2A*. This is one of the Fund's core areas, and its importance was highlighted by many Directors in past meetings.

Regarding the medium term, however, even if new resources are warranted in the coming financial year to carry out new tasks, significant uncertainties remain for the years ahead, especially at a time when the role of the Fund is being discussed. Hence, it is important to maintain flexibility when committing to staff increases over the medium term. As experience is gained it will be possible to better assess staffing needs. Furthermore, it is possible that after the startup effort needed in the first year for the poverty reduction initiative, some resources could be redeployed to cover or reinforce other areas. For this reason, while supporting the new proposal, I underscore that the new commitment for the second and third year should remain subject to revision, should new elements become available.

Mr. Zoccali made the following statement:

Mr. Chairman, allow me to echo the sentiments expressed by Mr. Bernes to the effect that there are no easy answers when it comes to medium-term staffing decisions. We appreciate the intense efforts of management and staff to move us towards a consensus in this regard based on the broad recognition that the major new initiatives entrusted to the Fund call for new resources. We also find helpful the reaffirmation of the commitment to continue with the restructuring of services and internal procedures in line with changing priorities to contribute to “financing” the new work of the Fund.

With this in mind, I will offer three observations on the issues at hand without repeating arguments made in previous meetings.

First, despite the attempt to make more explicit the possible trade-offs between proposed new and existing activities, significant uncertainties remain related, among others, to the sharing of responsibilities and improved cooperation with the World Bank and major stakeholders in the participatory process underpinning PRGF and PRSPs, as well as to the scale and timing of new activities. These justify, in our view, focusing the planning exercise more narrowly on the resource requirements to carry out planned activities in FY 2001, as suggested by Mr. Bernes. Such an approach would seem even more appropriate given that the pending report of the working group on stress could have additional resource implications, not reflected in the medium-term plans that have been presented.

Second, we welcome the proposal to incorporate in FY 2001 additional savings resulting from the planned review of internal review process and other economy measures that are expected for this year and beyond from the envisaged rotating reviews of OIA of the internal work practices and organization of area and functional departments. We continue to believe, however, that there is value added to be gained by supplementing this effort with an external review of the Fund’s overall internal procedures, including its budgetary process. This analysis might also usefully cover the efficacy of shared responsibilities with the World Bank. Similarly, looking ahead, greater emphasis should be given to working into the budgetary process a firmer dollar amount for administrative expenses, keeping in mind that upward dollar drift automatically impacts on the rate of charge, and that the traditional emphasis given to staffing ceilings cannot ensure greater budget discipline but could seriously hamper management’s flexibility to accommodate changing institutional priorities.

Third, the approach of excluding certain activities from the options presented for FY 2001, has meant added complications in our discussions. Nonetheless, on the basis of the new information distributed, this Chair is prepared to endorse today, the staffing level for FY2001 proposed in Option 2a* as a realistic basis for a broad compromise to bring this matter to closure. In going along with Option 2a*, in addition to the 30 staff years already approved in the FY2000 supplementary budget, I should underscore the priority this Chair attaches to maintaining enhanced technical assistance and training resources close to the level originally envisaged in Option 1. Similarly, we should ensure that External Media and Public Relations requirements do not take precedence over those related to core activities, such as enhanced surveillance, or absorb fully the margin of savings expected for the year. In any event, we believe strongly that the staffing option discussion for FY2001 should be brought to closure.

Finally, our preference would be to revisit the medium-term staffing plans as soon as firm experience can be had regarding the ongoing pilot projects, the shared responsibilities with the World Bank, the recommendations of the report on work-load and stress on staff and the conclusion of the envisaged reviews of internal procedures and processes.

Ms. Lissakers asked whether Mr. Zoccali's final comment meant that he considered that the numbers should be limited to 2001.

Mr. Zoccali confirmed that was the case.

Mr. Lushin made the following statement:

Let me say from the beginning that I can go along with Option 2a*, since in terms of the overall staff increase it broadly corresponds to what our Chair was suggesting during the previous Board meeting. Option 2a* provides additional savings of 16 staff years for FY 2001, an amount which is approximately equal to the requested new staffing for the External Communications Initiative. Therefore, the overall staff increase, including External Communications, fits the limits established under Option 2a, and this coincides with our position.

This said, I would like to make two points. First, I understand that the bulk of savings suggested under Option 2a* will come from the review of the internal review process. This review is only forthcoming, so how is it possible to foresee its results already now? In other words, what are the chances that the expected savings will materialize following the review? Let me also add that I share concerns expressed by Mr. Mirakhor in this regard.

Second, I continue to believe that in the medium term it is premature to commit large resources to the new initiatives, including on financial sector and Standards and Codes programs. I fully understand the importance of these programs, but their scale is so large and resource-consuming that we should not go forward with their implementation without prior consideration of the pace of this work by the Board. In particular, I am not at all convinced that for the sake of strengthening the international financial architecture we need to accomplish FSSA and ROSC reports for the entire Fund membership over a period of 5 years, as is envisaged in the medium-term planning options. It well may appear that significantly less effort may be sufficient to substantially strengthen the architecture of the international financial system. Therefore, while supporting the figures of Option 2a* for the FY 2001, I remain open-minded with regard to the staff increase for the FY 2003 which is suggested in this Option. I believe that such a decision should be taken at a later stage, for example, in one year from now. Then the Board will be able to take stock of the newly obtained experience with the implementation of these new initiatives and make a more reasoned decision on the pace of their realization.

Finally, if lower figure of staff increase is suggested than that envisaged under Option 2a*, I will be prepared to consider this proposal only in combination with the pattern of new staff allocation between initiatives. In other words, I agree with Mr. Portugal and Mr. Schlitzer that not only the overall figure of staff increase is important, but also the way it is allocated across programs and initiatives.

Mr. Collins made the following statement:

I remain disappointed that a more systematic analysis was not undertaken of the opportunity costs of the new initiatives. Paragraph 25 of the staff report speaks of the trade-offs in base services "in hypothetical ways." Directors requested that the staff look not at hypothetical trade-offs but what could actually be given up or sacrificed to make room for the new initiatives, because that is what will have to happen to some extent. Some sacrifices will have to be made.

I do find it unusual that we will be talking about the external relations paper within two days of this meeting, so I cannot help but give a preliminary comment on that. It, too, seems to suffer from the same defect as the original budget papers did. There appears to be no serious consideration given to reorienting existing resources to meet the identified new priorities. There are many such priorities, many of which do look worthy. But that is in addition to everything that the Fund already does, without much of an attempt to reorient, give up some things, and make room.

It is also a pity that the Board has not seen the report on staff stress, because I fear that at some point management will come forward with it in order to justify a demand for extra staff. It would be better if the Board could have seen the whole picture now, as it is available. However, from a reading of the report summary that the Managing Director circulated earlier, it would appear that improved management, rather than more staff, would be the way to address many of the problems.

I found the new options slightly obscure. For example, it would have been useful to know the activities that the 30 staff being authorized for this year are actually engaged in to get a better picture of where the additional staff for the next budget year will go. I presume that the deduction of 16 staff from Option 2A* would carry across Option 2B or Option 1. The fact that the staff focused on Option 2A* to the exclusion of anything else makes the table misleading. The headings or line descriptions are also misleading. The “net resource needs” are, in a sense, “gross resource needs.” The Board allocated 30 already for this year, but that does not represent savings. That is the line in total three, as it is called, what I call net resource needs. Referring to the 16 staff members that have been identified as “genuine” savings, 16 staff out of a total of 2,700 is not a huge proportion, which is why I think there is scope for more redeployment and saving. Table 2 lists “other Fund activities” and I suspect that there is padding in that line and a savings of another 11 or 12 staff could be realized, even under Option 2A*.

I have come to the conclusion that it is neither appropriate nor sensible for the Board to attempt to micromanage the process. It is the Board’s job to set priorities and a realistic budget—which might be demanding, but is realistic in light of the information we are given—and then to ask management to fit priority activities into that total.

Regarding the PRGF line in Paragraph 26, I understood from staff that in FY 1999 there were 30 ESAF-supported programs in operation, which involved six staff years per arrangement. For FY 2001 there are expected to be something in the order of 60 ESAFs, an increase of 30. There is no figure for how many ESAFs there are in the current year, and the increase in the number of PRGFs or ESAFs as opposed to the increase in the number of staff required per PRGF because of the new focus. Are the additional PRGFs next year included within these figures of additional staff, or are they related only to the deepening of the Fund’s work for ESAF? There is another total of staff dealing with the additional number of PRGFs coming on-stream. Or perhaps there is no increase from this financial year in the number of PRGFs, and my question is irrelevant. Is there some adjustment going on within the body of the current staff complement toward PRGFs? Do the figures reflect the deepening of the poverty eradication elements, or does the line in Table 2 capture whole new arrangements?

On providing more resources per PRGF, I am sympathetic to what management is trying to do. I also strongly agree with Ms. Lissakers that the Fund should not be doing the World Bank’s business. But we have to be intelligent, and that may involve adjusting and strengthening some of what the Fund does on the macroeconomic side, which may well require more staff, whether it is one per arrangement or not.

On FSSAs, the plan for the medium term to conduct 45 assessments per year is too high, given the premise that the whole membership will be assessed every five years. I am not sure that every country needs to be looked at every five years. However, 23 assessments for the forthcoming financial year is acceptable, so I do not question that. But I cannot judge whether the 21 assessments planned in Option 2A* is the right number or not. Only management can judge that.

> I agree with those who only want to focus on 2001 in this exercise, and am inclined to support a lower number than proposed in Option 2A*, perhaps nearer to Option 2B, although I would like that to include the staff required in the External Relations Department. I cannot help but be somewhat arbitrary as to the final figure. I do not think that it would make my presentation more convincing if I provided a total because it is not sensible to allocate in that way. Thus, I would like to propose a figure, including external relations, of 90 additional staff for FY 2001. In addition, 30 staff have already been accepted for this current year, so the total is about 120. If I could see some consensus emerging around a somewhat higher number I would move in that direction, but I do not want to give my bottom line at this stage.
>
> Finally, I support all of those who called for an external review of the budget process.

The Director of the Office of Budget and Planning said that regarding the number of ESAF countries, the program outlook paper showed that there were likely to be 24 active HIPC Initiative countries in 2001, and 37 by the end of the three-year framework.

Mr. Collins said that the table in the program outlook note appeared to indicate that there would be 24 active HIPC cases and another 33 active PRGF/PRSP cases, for a total of 57 cases. That was approximately the number of additional staff requested for PRGF, which would amount to one staff person per country. How many active PRGF/HIPC Initiative cases were there in 2000, compared with the forecast for 2001? It was assumed that there were not as many. If there were 50 and there were seven or ten more in 2001, was that separate from the numbers in the top line of Table 2? If it was, where did that appear?

The Acting Chairman asked whether all 57 cases would be active for the next year.

The staff representative from the Office of Budget and Planning replied that 57 cases would be active by the end of the year.

Mr. Collins wondered whether that meant there would be no increase in the number of cases.

The Director of the Office of Budget and Planning replied that there would be an increase in number of cases from 24 to 37 over the three-year period.

Mr. Woolford made the following statement:

> Like others, we think that it is not sensible at this stage to discuss the outer years and prefer to focus only on 2001. The proposal made by Mr. Bernes is a sensible way to go: a top-down approach where the Board fixes the number and allows management discretion in allocating staff among the various functions.

Like a number of Directors, however, we see technical assistance as a high priority, no matter what option is selected. I would like to ensure that the 2001 number is fixed at 17 staff in this area. We agree with Mr. Collins, Ms. Lissakers, and others who have emphasized that the Board should not micro-manage.

We also agree with a number of speakers that there is a pressing need for an external review of budget processes. Several of us called for that last year, and there was some support, but the process this year has reinforced the need for a review, and we place a high priority on it.

Last year, the staff increase that I agreed to was much higher than my authorities felt comfortable with, but at the time we made the statement that it was considered exceptional, as the staff had been under much pressure, which had to be eased. It is true that many new programs have been endorsed that will require resources, but we could go to as high as Option 2A*, as long as that included the numbers required for external relations and a review of budget processes. Without such a review, we could not go any higher than Option 2B, including the external relations staffing.

Mr. Prader made the following statement:

At this stage of the discussion, and especially since at our previous meeting Mr. Kiekens has already outlined the priorities and intentions of our chair, I can confine my remarks to the options submitted today.

But first let me point out that the Fund has grown significantly in recent years and that by 2001, the dollar value of the Fund's budget will have increased, according to some estimates, by more than 30 percent in just three years. The membership will have to pay the costs of this increase. This prospect requires us to be cautious in our eventual decision on an option.

Of the options presented today, the new Option 2a* is almost identical with Option 2a, as others have noted. For us the overriding concern, or to use Mr. Bernes's terminology, our "caveat" for surveillance, is the need to commit staff resources for enhanced surveillance, including resources for financial market research, as outlined by Ms. Lissakers. Unless it includes budgetary provisions for surveillance, we cannot agree to any option, including for that matter Mr. Bernes's magical number of 105. We are therefore disappointed that most of the "savings" offered by Management are in the area of surveillance. I want to be in the same boat as Mr. Cippà and Mr. Wijnholds, and if the proponents of "105" could explicitly agree to adding the commitment to enhanced surveillance, I could join this group.

In order to staff surveillance at a reasonable and prudent level, we propose that resources should be redirected from the areas of PRGF and

International Standards and Codes to surveillance. With respect to staffing for Financial Sector Stability Assessments (FSSA), we can accept the proposed number, with the understanding that at the review of the FSSA pilot project, the Board decides that the FSSA should be continued, under conditions that are acceptable to us. Assessing the stability of the financial sector is a core concern of the Fund. This was one of the main conclusions of the external review of Fund surveillance. For this reason, we have asked to adjust the pilot project to give the Fund sole leadership responsibility in the assessment of countries' financial stability. In our view, the Fund cannot delegate or share this responsibility with the World Bank. Achieving a clear division of responsibilities among the Bretton Woods institutions will avoid many pitfalls of poor coordination and compromised judgments. It will considerably ease the interaction between the Fund and country authorities. It will make the assessment process smoother and more effective, and from the budgetary standpoint, less expensive for both institutions. And if the conclusions of the review of pilot projects supports doing so, we could even agree to increase the Fund's staffing for FSSAs.

On the suggestion to have an external review of the budget process, I belong to the famous group of 10 Directors who requested such a review. I would just mention at this point that we should recognize that the budgetary process has never been as transparent as it is this time and that the staff has gone the extra mile in terms of providing information and organizing meetings.

I hope that the next Managing Director will continue the work projects that the present Managing Director has outlined in the medium-term budget statement. I hope he or she will not have terms of reference that will undo some of the good things done by the present Managing Director.

Mr. Tornqvist made the following statement:

First, I would like to support what has been said by others about the urgent need for an external evaluation of the budget process.

I agree with Mr. Bernes and others that we should avoid micro management. Nevertheless, it must be the task of the Board to set priorities. I have the same problems as Ms. Lissakers with the priorities that have been revealed by Management in specifying the options. My Authorities are particularly concerned with the low priority that has been assigned to enhanced surveillance, especially in Option 2b.

I still have difficulty in understanding the consistently high figures in all the options for the PRGF. Mr. Mirakhor referred to nine explanations for this in the paper. I am afraid that I do not find them very clarifying or convincing, partly for the reasons Mr. Shaalan mentioned.

I wish to remind the Board that this chair has so far taken the position that all the options are too high, including 2b. However, for the sake of compromise I can support the total figure under 2b at this stage, that is 84 new positions for 2001. I would like to point out that with the 16 staff members that can be redeployed according to Management's new findings, this alternative now provides more flexibility than before.

Mr. Bernes made the proposal that we should agree today on an overall figure for 2001, that includes any additional staffing needs for External Relations, and that we take no position on 2003 now. I would support that approach. However, I cannot agree to the figure he proposed, 105. I consider it too high.

Mr. Rustomjee made the following statement:

I would like to thank staff for the additional information provided for the discussion today, as well as for the helpful responses provided this afternoon to the wide range of questions asked. If anything, it tells me that much of the information is probably available and that to some extent, the endless iterations could partly be resolved through better packaging or repackaging of information.

I can be brief. Regarding the budget time period, I share the views of Mr. Bernes, Mr. Donecker, Mr. Cippà, and Mr. Woolford in respect of the time period for which the budget should be considered in this meeting viz: FY 2001 only.

On the issue of a fixed number, as proposed by Mr. Bernes, I take Mr. Portugal's view that adjudicating among priorities requiring the allocation of scarce resources is not micro-management, unless taken to an extreme level. Except in one circumstance, I would regard it as an abdication of the role of the Board in its responsibility to approve the organization's budget and to seek to ensure the financing necessary to ensure that the broad priorities for future work can be given effect to. The one circumstance is when there has been a detailed, exhaustive, unresolved outcome to the iterative process between management and staff, on the one hand, and the Board, on the other. In my view, we have not got there yet. At least one additional step—and I consider it to be a logical step, is the provision of some references to costs along the lines asked for by Mr. Taylor—but more detailed—and along the lines outlined by Ms. Lissakers.

Finally on the issue of options, we continue to favor option 1. It gives the minimum or probably less than that, to our staff, even in the sub-optional scenario in which the African Department is already operating. In fact, we favor option zero, or whatever would be the name of the option which assigns as much resource to enhancing in-country capacity, as it does to strengthening our institution's capacity to deal realistically with its new poverty mandate.

Turning to Option 2a and Option 2a*, under the new Option 2a (Option 2a*) the staff savings resulting from the reorganization of the support services in the Fund is certainly welcomed, and we trust that the planned reviews of other functional and area departments will lead to further savings in the future.

The staff also proposes under the new option (2a*) an increase in technical assistance in the outer years by four staff years which is appreciated. However, such increase is made at the cost of reduced work for PRSPs, PRGF, and HIPC Initiative. This is hardly understandable, given not only the priority and urgency attached to this work, but also, as the staff themselves asserted, the fact that the work in this area should be expected to increase. Moreover, if implemented, this option will imply a reduction in the number of countries that will benefit from these initiatives by at least six when compared to option 1, and three countries when compared to Option 2a.

In conclusion, if option 1 is not feasible, our preference would be for Option 2a for FY 2001, provided that if any unexpected savings emerge during the year, that they be allocated to the enhanced technical assistance category or, preferably to building in-house capacity in PRGF countries.

Finally, we also support the need for an external review of the budget process.

Mr. Oyarzábal made the following statement:

I thank the staff for the additional information they put forward in the paper and the answers given to different questions that have been raised in the course of the Board's discussion.

My comments focus on the idea that the staff is overstressed, which means that there are even greater needs than those that have been put before the Board, as well as the alternatives that have been discussed in the past few days. I would also like to recognize the efforts of the staff in savings and redeployment, which respond to the mandate not only in the overall configuration of the proposals, but also in the efforts in these areas of savings.

As Mr. Portugal, I would favor phasing out activities in the financial sector. The figures set out in the papers are too high and are not likely to be achieved, particularly during the course of 2000–2001.

I agree with the significance of the qualitative distribution of the resources as opposed to considering an overall number, as proposed. The last two years in this budget exercise were indicative of the direction that the Fund would take in the near future, subject to review and adjustments and not a final commitment.

I support Option 2A* and would be able to go higher than the figure of 105 new hires if the additional staff were dedicated to external relations.

Ms. Lissakers commented that she had not expected an alternate Director appointed by Venezuela to argue for fewer financial sector assessments by the Fund.

Mr. Shaalan made the following statement:

The staff representatives in their answers today have helped shed further light not on all the issues, some of which are quite complex, but at least on some of the questions that we, as well as other Directors, raised during the last Board meeting. I have already expressed my views on the resources devoted to poverty reduction, and might repeat my concern with the Fund devoting resources to social activities that should remain the domain of the World Bank.

Our main difficulty with the options presented by the staff has less to do with the overall level of resources than with the distribution of resources among the various activities, which has been done by reducing the resources allocated to the Fund's core activities. Like Mr. Portugal, we find it difficult to come to a conclusion about the appropriate level of staffing for the financial sector work. There must be a review of the initiative following the completion of the pilot project. It is difficult at this stage to estimate the staffing requirements for the initiative before that review, but I will support the staff requests for this purpose only because it is a core activity for the Fund that must receive considerable attention.

We are deeply concerned about the level of work-related stress among the staff. That is not all related to management, but I will not pass judgment on where the problem lies before the report is released and we have a discussion. Any increase in staff resources for the purposes of reducing the workload should be accommodated in the FY 2001 budget. That was indicated in the Managing Directors' statement at the conclusion of the discussion on the medium-term planning options on January 12, which states: "The necessary budget requests will be presented in the FY 2001 administrative budget to be submitted in March 2000."

The Board must come to a conclusion on the budget, and therefore I am prepared to support the consensus, but only for the 2001 budget, postponing the consideration for the outer years until the Board is in a better position to make a considered judgment.

Mr. Kelkar made the following statement:

> Let me thank the staff for providing further information and a new alternative. Like Mr. Bernes, I would also point out that the savings of 16 staff perhaps should be available to other options. I agree with him that the Board should perhaps only consider FY 2001. To my mind, Option 2A* is an acceptable variant, with one qualification, that there should be an upper limit of 98 additional staff during 2001. Within that number the allocation could be left up to management's judgment. I agree that the Board should not get into micromanagement and defining how many people work in precise areas.
>
> The Board should undertake as early as possible the evaluation process and improve our budget process, and also improve the work in the area of PRGF. It has occurred to me, for example, to suggest that management consider opening an office in Africa, along the lines of the one in Paris, to help administer important programs, improve interaction, and increase supervision, while helping reduce costs and improving delivery.
>
> Regarding the allocation of resources, I will leave it to management to decide the numbers, within the upper limit of 98 new hires. However, the allocation for technical assistance should not be diminished because it is an important activity of the Fund in terms of crisis prevention.

Mr. Mirakhor said that he supported Mr. Kelkar's proposal for establishing an office in Africa, and was grateful for the suggestion. There were Fund offices in both Asia and Europe; Africa was important to the Fund and such an office might help to substantially cut costs.

Mr. Barro Chambrier said that he would also support further exploration of Mr. Kelkar's proposal.

Mr. Wijnholds made the following statement:

> One of my major concerns in addressing this matter is to avoid turning the Fund into a second World Bank. A certain leanness must be maintained. However, it is important to combat overwork by the staff, and I am looking forward to the stress report. It is also necessary to tackle the matter of the budget process and involve external experts, as I have said before.
>
> My starting point is Option 2B, and from that I would add a number of people for enhanced surveillance. That should not be cut out completely. We also want to preserve technical assistance to some extent. On that basis, I would suggest about 100 additional staff, excluding the increases in external relations. In the spirit of compromise, I want to join Mr. Bernes' figure of 105, including external relations, although that is my bottom line.

Mr. Wei made the following statement:

At the outset, I thank management and staff for providing us with additional information on Medium-Term Planning Options which will facilitate today's discussion. It is quite obvious that staff have made great efforts to save resources through redeployment while trying to keep the main initiatives unchanged. The staff statement has answered the major concerns expressed by my colleagues during the previous discussion on this issue. In this context, I hope that the Board could produce a consensus today. Since my chair's position remains unchanged, I will just make some brief comments.

As we discussed during our recent Board retreat, it is my view that the Fund should focus on its core areas, especially on surveillance and the financial sector. It is without a doubt that the implementation of the new initiatives would further strengthen these core areas. Therefore, I expressed my support for Option 1 during the previous discussions.

While Option 1 is my preference, in the spirit of cooperation, I could accept Option 2a*. However, like others, I would emphasize that PRGF and HIPC Initiative activities as well as technical assistance must be supported with adequate staff resources. We are also of the view that the social sector related work shall be undertaken by the Word Bank so that our institution will be able to concentrate on its mandated responsibilities.

I join others in supporting Mr. Kelkar's proposal to establish a Fund regional office in Africa.

Regarding the External Communications Initiative, I am looking forward to the upcoming Board discussion on this new strategy.

Finally, I would like to reiterate my authorities' view that the workload has increased to such an extent for the Chinese Section of BLS that a further increase in staff is urgently needed. I hope management could seriously take into account my authorities' request.

Mr. Harinowo made the following statement:

At the outset, I would like to join other Directors in thanking the Management and staff for preparing the new proposal which has shown further flexibility on Medium-Term Planning Options.

During the previous meetings, our chair has indicated our preference for Option 2a with slight modifications. In particular, we indicated the importance of the technical assistance and training. Therefore, we said during that meeting that for the technical assistance, further enhancement might

> demand additional resources in the amount of 19 staff years for FY 2001 and 21 staff years for FY 2003 as was proposed in Option 1 for the particular area.
>
> With regard to the total additional staffing needs, the Option 2a proposed 144 staff years. However, with expected savings from the internal review process and other savings, the new proposal came to 128 staff years. This number certainly falls within the range of the total additional staff that we have in mind. Therefore, we fully support Option 2a*, and commend the staff for their efforts in producing additional savings.
>
> With regard to the distribution of these resources, as we indicated earlier, our preference is to have the technical assistance and PRGF Initiatives at least as initially planned under Option 1. We will leave to the management as to how the distribution will be done.

Mr. Donecker said that he was in favor of Option 2A*.

Mr. Mirakhor asked whether the three Directors who had supported Option 2A could agree to Option 2A*, with a view to arriving at a consensus.

Mr. Rustomjee responded that he appreciated Mr. Mirakhor's comment. He supported Option 2A, but in the interest of a consensus would be prepared to support Option 2A*. However, that position meant that fewer countries might be encapsulated under the PRGF and HIPC Initiative framework. He would also only support Option 2A* for FY 2001. No account was being taken of the issue of empowering the countries concerned with capacity, an issue that he would come back to in the future.

Mr. Wei said that he supported Option 2A* but remained concerned that technical assistance activities should not be maintained by a reduction in PRGF.

Ms. Lissakers regretted the lack of clarity vis-à-vis EXR. A number of Directors had said that they were including the EXR enhancement in their position. What was management's intention in dealing with EXR? The Board would discuss the matter later in the week; would management then come back with a new staffing proposal incorporating additional personnel for that purpose?

Mr. Mirakhor said that those Directors who had supported Option 2A* had excluded the additional numbers required for EXR.

The Acting Chairman noted that management had decided at the June 12 Board meeting that there would be a paper on the external relations initiative. That issue and the staffing implications would be discussed separately.

Mr. Collins clarified that while the Managing Director had said the two issues were not linked, he and several other Directors supporting a variety of positions had suggested numbers that included the external relations initiatives.

The Acting Chairman said that in counting all of the votes, that difference would be made clear. Mr. Kelkar, for example, had said that he would support Option 2A* with any external relations increase included, which was not the Option 2A* proposed by management.

The Secretary indicated that there was a majority in favor of management's proposal for Option 2A*, excluding external relations.

Mr. Prader said that if enhanced surveillance was not included in Mr. Bernes's caveats, he supported Option 2A*.

Ms. Lissakers wondered whether Mr. Bernes' figure of 105 new hires assumed a zero increase in enhanced surveillance, which Mr. Prader appeared to suggest.

Mr. Bernes replied that he was not assuming that there would be a zero increase in enhanced surveillance. He had suggested that the precise allocation be left to management's judgment, taking into account the priorities established by the Board. Enhanced surveillance would be such a priority, so that would be an important allocation.

Mr. Prader reiterated that technical assistance and enhanced surveillance were an overriding concern. If management was left to do what it wanted vis-à-vis enhanced surveillance, small European countries could be adversely affected. If enhanced surveillance was explicitly included as a caveat, Mr. Prader would support Option 2A*.

Mr. Woolford asked about the percentage of the vote in favor of an external review. If the majority wanted an external review of the budget processes, what were the numbers vis-à-vis Option 2A*, including external relations?

Mr. Donecker said that the issue of the external revenue of the budget process was not the subject of the current discussion. The Budget Committee should decide on that rather than a majority view sought at the current Board meeting.

The Secretary said that the various arguments and suggestions had been noted. A number of Directors, including Messrs. Cippa, Prader, Tornqvist, and Pickford, had suggested that they could support Mr. Bernes' original proposal, but they favored a lower number of staff, and their views had been recorded. However, there appeared to be a majority in favor of management's proposal, Option 2A*, excluding external relations. None of the Executive Directors who favored alternative proposals, including Mr. Bernes's proposal or variants thereof, was included in the total for Option 2A*, thus there was no overlap between the two categories.

Mr. Tornqvist wondered whether Option 2A* was counted as taking a decision on both FY 2001 and 2003.

The Acting Chairman responded that Option 2A* applied to 2001.

Mr. Shaalan said that he would join the consensus.

The Acting Chairman made the following summing up:

Today's meeting follows the recent discussions on this subject in the Board, as well as in the Committee on the Budget, during which the major initiatives and Directors' views on resource implications were discussed in detail. I would like to thank Executive Directors for their further views. The discussion today has provided further guidance on how Directors prioritize the major new initiatives, and a further indication of their views about the pace of implementation of these initiatives.

In terms of the options, I think that there is broad support for Option 2A* as it applies to FY 2001, which, in accordance with the presentation in BUFF/00/14, calls for a net increase of 98 staff years in FY 2001, excluding the external communications initiative. I know that not everybody is happy with the outcome, which is a compromise; some Directors, and management, think that a higher number of additional staff are needed, while others would feel more comfortable with a lower ceiling, including any staff resources agreed upon for the enhancement of media and public relations. But that is the nature of a compromise. At least this option will enable the Fund to continue with its work on the major new initiatives.

The indications for FY 2001 will be helpful to management when we formulate the next budget. Based upon the guidance received from Directors, the staff will now proceed with the preparation of the Administrative and Capital Budgets for FY 2001. These will be discussed initially by the Committee on the Budget in March and then by the Executive Board in April.

I have noted that Directors were not prepared, at this stage, to discuss the resource needs for the outer years beyond 2001. It is clear that we live in a fast-changing world, not least with respect to the Fund's role and responsibilities. As has become very clear with respect to the new initiatives, it is difficult for us all to estimate with precision what they will require in terms of staff resources. It will therefore be sensible to reassess the needs on the basis of further experience, including at the time of the next medium-term budgeting exercise.

As regards the budgetary process itself, I have noted the suggestions made by Directors to improve the process, and I have noted the proposal by most Directors for a systematic external evaluation of the Fund's budgetary process and internal operations. Management looks forward to working with the Evaluation Group on a proposal for an external evaluation of the Fund's internal procedures that could be considered by the full Board. As you know, we have undertaken a study of best practices in budgeting, which was discussed by the Budget Committee in November, and we have already incorporated some improvements. Management has also asked the Office of Internal Audit and Inspection (OIA) to review the organization and work practices of area and functional departments on a rotating basis. In doing so, OIA will seek outside help, as needed.

Finally, on the issue of work pressure and stress within the Fund, several Directors expressed support for management's efforts to address this problem. A number of Directors regretted that this discussion on the options for FY 2001 has taken place ahead of the discussions on the stress report and on the external communications initiative. They looked forward to a fuller discussion of these two issues as soon as possible.

4. MAURITANIA—ENHANCED INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—DECISION POINT

The Executive Directors considered a paper, prepared jointly by the staffs of the Fund and the International Development Association, on the second decision point for Mauritania under the enhanced Initiative for Heavily Indebted Poor Countries (EBS/00/5, 1/14/00; and Sup. 1, 2/2/00). They also had before them the Chairman's summing up of the meeting of the Board of Executive Directors of the International Development Association (FO/DIS/00/16, 1/28/00).

Mr. Barro Chambrier submitted the following statement:

My Mauritanian authorities are highly appreciative of the support of the Fund staff as reflected in the decision document which gives an accurate picture of Mauritania's indebtedness and presents the assessment of its eligibility under the Enhanced Debt Initiative for Heavily Indebted Poor Countries (HIPC).

A country with limited resources, with mainly two main export products (iron ore and fish), nomadic population and poor social indicators, Mauritania has nonetheless managed a successful dual transition to economic and political liberalization, and constitutes a good case to be considered under the enhanced HIPC Initiative. Since 1985, Mauritania has been implementing a long and satisfactory track record of a comprehensive macroeconomic adjustment and far-reaching structural reforms under six consecutive Fund-supported programs years, with the financial assistance of other multilateral institutions and bilateral donors and creditors. The Executive Board approved the fourth ESAF-supported arrangement covering an additional period of three years on July 21, 1999.

As a result of these continuously sustained adjustment efforts, macroeconomic performance improved significantly. Over the period 1993–98 annual real growth rate has averaged about 5 percent compared with about 1 percent over 1990–92. National saving relative to GDP has increased to about 20.0 percent in 1998 from 12.1 percent in 1993, mainly on account of significant increase in private saving, while the average annual inflation rate declined moderately to 6.2 percent during the period under consideration.

Progress was achieved as well in other areas, particularly with regard to fiscal consolidation. Stemming mainly from the successful reform of indirect taxation (with the introduction of the VAT in 1995) and some improvements in tax administration, significant improvement in government revenue was achieved. Domestic tax revenue excluding grants reached close to 27 percent in 1998 from about 26 percent of GDP in 1993. In the meantime, non-productive expenditure declined, with the wage bill contained and defenses expenditures declining in real terms. These developments led to a steady reduction in non-interest current expenditures, while making provision for an increase in social sector expenditures. As a result, the fiscal position has shown significant improvement with the primary fiscal balance (excluding grants) shifting from a deficit of 6.9 percent of GDP in 1993 to continuous surpluses after 1995; the overall balance also registering surpluses, over the past three years.

Mauritania has also carried out a wide range of market-oriented structural reform measures since 1992, including in the areas of economic management, fishing, rural development, banking and the public enterprises, among others. These reforms have helped to improve economic efficiency and growth, and have contributed to the creation of new employment opportunities. Important progress was achieved in the external sector, as the exchange system was unified and gradually liberalized. However, despite progress achieved in this area including: the elimination of the requirement of prior approval by the central bank for most current account transactions; the creation of an interbank foreign exchange market; and the licensing of more than 40 foreign exchange bureaus, deficiencies in the functioning of the market remained, but were addressed by the authorities by allowing the exchange rate of the ouguiya to depreciate.

In the area of social policies significant progress has been achieved. Important reforms in education, health care, and initiatives aimed at reducing poverty were undertaken by the government during 1992–98, including increased spending in social sectors that helped improve the quality and effectiveness of its social expenditure program. Total social expenditures which averaged about 21 percent during the period 1990–92 have reached 28 percent in the period 1993–98, with particular emphasis put on education, health and specific poverty reduction programs. As a result, it is estimated that the incidence of poverty as a whole fell from 57 to 50 percent between 1990 and 1996. Particularly worth noting, are the progress achieved in the education and health sectors. In the area of education, total gross primary school enrollment and enrollment in secondary education increased notably particularly for girls. In the health sector, health sector operations have gradually improved as the budget allocation for recurrent expenditures have been increased by 0.5 percentage point annually, and the number of functioning primary health facilities expanded.

Satisfactory macroeconomic framework was maintained during the first nine months of 1999, with the evolution of monetary aggregates remaining consistent with projections at end-September; the average inflation rate for the twelve months declined from 8.1 percent in January to 5.6 in September, and foreign exchange reserves of the central bank reached US$231.5 million at end-September 1999, higher than initially projected. However, budget execution was somewhat less satisfactory at end-September. With measures taken in the fiscal area, including strict expenditure control and strengthened tax collection efforts, the authorities should comply with the end-December performance criteria on the overall fiscal balance. On the structural front, the execution of measures included in the PFP matrix is proceeding according to the calendar. Moreover, to enhance the responsiveness of the exchange rate to market indication and reduce the existing spread between the interbank and the parallel market rates, the central bank has recently started to operate biweekly buying and selling sessions of cash foreign exchange directly to foreign exchange bureaus.

The 2000 draft budget was adopted consistent with the approved program, with revenue projected to decline from 27.7 to 26.1 percent of GDP owing to the expected decline in custom revenue and SNIM's dividend payment. Expenditure is projected to decline from 25.6 to 24.9 percent of GDP. However, consistent with the changes in the HIPC Initiative, the draft budget for 2000 doubles the share of budgetary resources allocated to well-targeted poverty reduction programs, as well as substantial increases in health and education expenditure, in line with the medium term social objectives of the PFP. This will entail a decline of the fiscal surpluses registered in the past consistent with macroeconomic stability and the important external financing support.

In light of these achievements and taking account of the necessity to tackle the remaining impediments to growth, the authorities have adopted a medium-term program that will enable them to consolidate the gains achieved in the past in reducing financial imbalances, accelerate the reform process, and reduce poverty. The economic program for 1999–2002, in support of which the Fund has approved a new three-year ESAF in July 1999, seeks to achieve an average real GDP growth rate of about 5 percent, maintain inflation below 3 percent and reduce the external current account deficit to about 10 percent of GDP by 2002.

It is worth noting that the strategy envisaged by the government to reach the completion point, focuses on consolidating and improving macroeconomic stability (including the implementation of an effective and comprehensive program of social expenditure), and will depend heavily on the rational and gradual decline of budget surpluses to increase spending in social sectors and infrastructure, but also on the resolution of the heavy debt burden, in order to reach higher growth rates than those envisaged under the current program.

Fiscal policy contemplated in the medium-term program will focus on increasing public sector savings by expanding the tax base, while reducing the tax burden on enterprises. These actions will be paralleled with the reduction of the scope of exemptions, and continued reforms of the tax system and a strengthening of tax administration. As regards revenue measures, the main actions will aim at the unification of the VAT rates starting in 2001, and the revision of special tariff schemes. Other actions will target the elimination of special exemption regimes, an overhaul of the direct taxation system, the establishment and strengthening of a large taxpayers unit, and adoption of a standard bidding documents for public procurement contracts to increase transparency and good governance. In addition, the last phase of the tariff reform will be implemented in 2000, so as to harmonize Mauritania's tariff structure with that of the West African Economic and Monetary Union countries. Finally, the government plans to strengthen its administrative capacity and raise the quality of government decision-making by reorganizing the civil service and improving transparency. A better monitoring and control over expenditure will supplement all these policies.

As regards monetary policy and financial sector reform, the Central Bank of Mauritania (CBM) will pursue prudent monetary policy in order to consolidate the gains attained in the past with regards to inflation and balance of payments objectives, while relying more on indirect instruments for the management of liquidity. In this context, my authorities are committed to encourage measures that would lower interest rates and boost private sector investment. My authorities are particularly attentive to the deepening of financial intermediation. In that vein, the soundness of the banking system and competition will be further encouraged during the program period, by strengthening the structural reforms and measures already introduced in this area. In particular emphasis will be put on the compliance of all commercial banks with prudential ratios for risk concentration.

The external current account deficit is projected to decline slightly over the program period. Particularly pivotal to the success of the medium-term program is the effectiveness of the exchange market. Thus, to strengthen the external position of Mauritania, my authorities are committed to further liberalize the exchange and trade systems, and maintain their policy of a managed float to enhance competitiveness of exports and reduce the spread between official and parallel rates. In this context, measures to make the exchange rate more responsive to market conditions include the elimination, by June 2001, of the obligation for all exporters (including SNIM) to surrender their proceeds.

The authorities are in agreement with the views expressed by the staff on the importance of pursuing and deepening the planned structural reforms through the redefinition of the role of the government, essential to restore private sector confidence. Consistent with these objectives, the authorities plan to accelerate the public sector reform by privatizing a large number of public enterprises in key sectors (transportation, water, electricity), as well as other public enterprises of smaller size operating in various sectors.

Structural reforms will also include measures aimed at creating an enabling environment for private sector development and investment promotion. To that end, the government is committed to promote policies that will improve the functioning of the judiciary system and the overall regulatory environment, while pursuing and deepening the reforms already started in the fiscal and financial sectors, focusing on the further liberalization of the foreign exchange market and trade. Consistent with policies introduced in the neighboring CFA Franc zone countries and provisions of WTO, the tariff structure will be streamlined including a reduction of the maximum rate. Other structural measures will also be introduced and will apply to the implementation of a modern commerce and arbitration codes. To supplement these measures, key sectors including the fisheries and agriculture (rice) are also targeted for reform in order to improve private sector participation, efficiency and the reduction of government involvement.

My authorities remain concerned by the low quality of social indicators, despite tangible progress achieved in the past. But beyond these measures, and pending the impact of the HIPC Initiative, my authorities intend to continue improving development of human resources and alleviate poverty, through targeted sectoral measures directed at health and education sectors, and employment.

My authorities are aware that growth-oriented macroeconomic adjustment alone is not a sufficient condition to reduce poverty and have developed a strategy for poverty reduction that constitutes an excellent basis for the development of a well-articulated and fully participatory Poverty Reduction Strategy Paper (PRSP), and are committed to get civil society rapidly and fully involved in the process of developing and implementing the country's Poverty Reduction Strategy and to finalize the PRSP by end-2000. Immediate steps to alleviate poverty include redirecting public expenditure toward priority social sectors, through the Commissariat aux droits de l'homme, lutte contre la pauvreté et à la reinsertion that was created to this effect.

In this context, the Action Plan for the Fight against Poverty for the period 1999–2002 which has been launched aims at: generating income for the poor; achieving human development; and enhancing welfare in general, which will necessitate a considerable level of technical assistance to enhance capacity building. In addition, the government has launched an ambitious nutrition program, aimed at improving the nutritional status of mothers and children.

The Mauritanian economy remains highly vulnerable to external shocks, continues to face an unsustainable debt burden, and is heavily dependent on concessional assistance. Nevertheless, the authorities are determined to remain current on their outstanding external obligations and prevent the emergence of new arrears. As the Debt Sustainability Analysis shows, Mauritania has unsustainable debt burden under both fiscal and export criteria, even with the full application of traditional debt relief mechanisms. This burden is even heavier as the country depends mainly on two main export products—fish and iron ore—of which fisheries products account for more than 50 percent on average of exports of goods and services. Moreover, the economy experienced, over the last two years, deteriorating terms of trade which has been exacerbated since 1998 by the severe crisis in the fisheries sector as both catches and international prices for high value species dramatically fell owing to the Asian crisis. These developments served to increase the debt-service ratio and to impede sustainable development despite efforts undertaken by the authorities in various sectors.

Therefore, for a timely achievement of these objectives, faster and deeper assistance to Mauritania under the HIPC Initiative is deemed essential. The government broadly shares the analysis of the staff on debt sustainability. However, in view of the long track record established, my Mauritanian authorities are of the view that the final decision point should be set in 2000 and that the floating completion point should be set not later than the year 2002. They intend to have the completion point triggered sooner than later by the successful implementation of a set of pre-defined reform measures under the PRGF. Consistent with these goals, my authorities intend to request a new rescheduling from the Paris Club and to seek debt relief from non-Paris Club bilateral creditors on terms at least comparable to those granted by the Paris Club. In addition, they expect to benefit from interim and exit assistance under the enhanced HIPC Initiative in line with the guidelines of the recent Cologne summit after setting of the final decision point. My authorities agreed that reflecting the recent changes to the HIPC Initiative methodology, the amount of assistance under the HIPC Initiative should be calculated at the decision point, which is assumed to be early 2000, and based on end-1998 data and hope that for Paris Club creditors, delivery of the required assistance would include granting additional relief on ODA loans and/or on post-cutoff date debt.

To conclude, I would like to stress my Mauritanian authorities' determination to speed up their efforts to deepen the macroeconomic and structural adjustment, to foster growth, increase per capita income and generate employment. My authorities in view of their good track record have demonstrated their capacity to implement ambitious agenda of reforms and are confident that they will successfully implement the program package discussed in their memorandum. Thus, they hope to benefit from continued financing under concessional terms, as well as from the benefits provided by the international community under the enhanced HIPC Initiative in a coordinated manner to supplement their efforts that will result ultimately in improvement in living conditions for the Mauritanian population.

The Board support of the authorities' request under the HIPC Initiative will certainly make a significant difference in their efforts, and enable the country to accelerate social and infrastructure reforms so as to alleviate poverty, improve the social indicators and basic infrastructure, and also strengthen investor confidence.

Mr. Milleron submitted the following statement:

I welcome this presentation of the final HIPC Initiative decision point document for Mauritania, following its deferral decided during the summer. We are now able to address this country in the new framework of the HIPC Initiative and increase our support for poverty reduction.

I will try to be brief, in focusing my comments on the main issues for discussion. First, I support Mauritania's eligibility for debt relief under the enhanced HIPC Initiative. As this eligibility is obvious under both the export and the fiscal criteria, I agree that the fiscal criterion is relevant to provide in this case the required reduction of the NPV debt.

Second, regarding the timetable, Mauritania's track record would have allowed a decision point in July 1999. Consequently, I fully support the approval of the decision point today and I agree to consider that the track record for the second stage started in July 1999. In this regard, I would appreciate the staff's further elaboration on the share of relief to be provided under the interim assistance.

Third, I agree on the principle of a floating completion point and I support in particular the prospect of a PRSP followed by one year of successful implementation. This being said, I wonder about the set of actions and triggers mentioned in box 7, even if I can broadly go along with it. In fact, I would like to be sure of the feasibility of the measures and objectives which are required to reach the completion point by July 2002. I would appreciate it if the staff would elaborate on this matter. More specifically, I wonder if the foreseen timeframe is realistic enough and if some requirements make sense, as they are currently worded. For instance, I have reservations on the relevance of the last objective mentioned in Box 7, which is to maintain the HIV prevalence rate at the level of 1998. I must be clear: I fully support that the benefit from the HIPC Initiative contributes to strengthen the fight against this disease, which is a top priority, but can we require the authorities to be able to contain the HIV/AIDS prevalence rate in the short term, say a couple of years? I agree that the Mauritanian authorities must make every effort to tackle the spread of HIV, but it would be erroneous to consider that the outcome is really under their control at the present time. In addition, the verb "to maintain" is not really appropriate in this area.

Fourth, regarding the DSA and the assistance under the enhanced HIPC Initiative, I have to confess that I was somewhat surprised by the staff's presentation of Mauritania's debt sustainability after enhanced HIPC Initiative assistance, involving debt ratios largely above the targets at the completion point. I understand the reasons given by the staff to explain this particular case, namely the stagnation of Mauritanian exports and the accumulation of new debt in the meantime. I am also aware that the amount of the HIPC Initiative assistance is consistent with the current framework of the initiative, namely the fact that the calculations are made at the time of the decision point. Nevertheless, I am a little disturbed by the rapid pace at which the country's indebtedness is expected to pick up. I would appreciate more explanations from the staff on this phenomenon. For instance, regarding the new debt, could Staff provide us some indications about its level of concessionality?

Finally, as mentioned by the staff, I would like to underline that both the assumptions and the resulting debt projections are provisional. Indeed, the reconciliation process on debt data is still ongoing. Of course, the revision of the current preliminary data could have an impact on the estimated required assistance.

Concerning the Paris Club, it has been agreed to consider Mauritania after it has reached its decision point. This should be the case in March 2000, during the next meeting of the Paris Club. At this time, as interim assistance from the Paris Club, Mauritania should benefit from a concessional flow rescheduling, under the terms agreed at the Cologne summit. Then, at the completion point, this rescheduling will be followed by a debt stock operation. In addition, on a bilateral basis, most of the Paris Club creditors intend to cancel the ODA debt of Mauritania, according to modalities yet to be defined.

As for the non-Paris Club creditors, I note that a part of the passive debt, which was totally excluded from the previous baseline scenario, is now incorporated in the calculations of the amount of debt to be addressed, as two creditors have now reactivated their passive debt. Could the staff specify the amount of the debt claimed by these two non-Paris Club creditors? What lessons can we draw from this situation?

Mr. Morais submitted the following statement:

Mauritania has established a credible track record of adjustment and reform on the macroeconomic, social and political fronts. Inflation is now in the single digits, substantial structural reforms have been implemented and fiscal consolidation has been achieved. Reflecting this effort, GDP grew by an annual average of close to 5 percent since 1992 and there has been significant improvement in social indicators. We are in broad agreement with the thrust of the program for 1999–2002 which seeks to further consolidate these achievements and we welcome, from Mr. Barro Chambrier's statement that the authorities are making progress in implementing the policy measures.

We support the country's eligibility for debt relief and as the calculations show, Mauritania qualifies for debt relief under both the export and fiscal criteria. We support using the fiscal criterion to allow the country to fully address and alleviate its debt burden. We agree that the decision point be today and to also take into account that the track record for the second stage started July 1999.

Given that the authorities have demonstrated strong commitment and capacity to put external assistance to good use, we are confident that debt relief will allow them to make further and impressive progress towards the alleviation of poverty. Box 5 of the staff report show that the authorities are adopting a comprehensive approach and taking everyone aboard in making adequate preparations for the successful implementation of the PRGF.

Delivery of relief through floating completion points should accord the authorities the necessary flexibility and incentives for timely policy implementation in order to access resources earlier. However, the conditions laid down by the staff appear rather too onerous, particularly those pertaining to the social sector and poverty reduction, given that the country's administrative capacity is limited. For example, between 1990 and 1996 the incidence of poverty was reduced by 7 percentage points. Could the staff clarify over what period of time have they set a target of a further reduction by 10 percentage points?. While welcoming the targets set for improvements in primary and secondary education and enlarged access to health care and nutrition, we wonder whether enough interim assistance will be provided to make these targets achievable and enable the country to reach completion point by July 2002. Finally, we share Mr. Milleron's concerns on whether the target on HIV prevalence rate is achievable and if successful, such a program would be useful to many other countries affected by this epidemic, the staff's clarification would be appreciated.

Mr. Daïri submitted the following statement:

We thank the staff for an excellent paper, and Mr. Barro Chambrier for his helpful statement. We support Mauritania's eligibility for debt relief under the enhanced HIPC Initiative and agree that July 1999 should be the starting point for the track record under the second stage. We also support the use of the fiscal criterion for the calculation. We take note of the staff's remark that "bilateral creditors are unlikely to reach their required share of assistance with an NPV reduction of up to 90 percent of eligible debt." We welcome in this connection Mr. Milleron's indication that Paris Club creditors intend to cancel the ODA debt of Mauritania.

Like Mr. Milleron, we are concerned by the levels of debt indicators at the completion point. Our concerns are heightened by the fact that these indicators could be underestimated as passive debts are excluded from the DSA analysis. The fact that two creditors have claimed their "passive debt" reinforces our view that this issue adds to the vulnerability of Mauritania. In our statement during the discussion of the preliminary document on HIPC Initiative for Mauritania, we suggested that all claims under passive debt that are not formally cancelled by a given deadline should be included in the calculations. This approach would secure either cancellation of the claims or their treatment under the HIPC Initiative. Unfortunately, the approach taken by the staff of excluding "unclaimed passive debt" after a given deadline maintains a debt overhang and does not provide adequate incentive for its treatment. The lack of data on passive debt in the staff document is also of concern. The preliminary HIPC Initiative document (EBS/99/3) contains detailed information (Box 5) that passive debt has totaled US$593 million at end-1998, and would require additional assistance of US$307 million if included in the DSA analysis. We would like the staff to update these figures.

Moreover, as also indicated in our above-mentioned statement, we do not see much consistency in excluding fishing royalties from exports as provided for in the Fifth Balance of Payments Manual and including such royalties among government revenue for computing the debt/revenue target. We therefore reiterate our proposal for excluding this highly volatile item from budget revenue for the purpose of debt reduction calculations, especially in view of the fact that renewal of the fishing agreement with the EU will depend on the outcome of the assessment of available resources at the expiration of the current agreement in 2001.

The staff assume that the floating completion point will be reached in July 2002, which means an interim period of three years. This assumption does not take into consideration the views of the Board at the January 1999 meeting; and I quote from the summing up "many Directors suggested shortening the interim period to end in late-2000 or the first half of 2001 in order to help achieve early debt reduction." While it is true that a small majority supported the staff proposal for a completion point in the first half of 2002, this does not necessarily mean July 2002. Moreover, in view of the divergent views among Executive Directors, it was agreed that the issue will be revisited at the time of the decision point. The staff may wish to indicate the extent to which this issue has been revisited in the decision point document.

Furthermore, we are of the view that the staff's proposal puts an extremely heavy burden on the authorities and does not recognize their track record of policy implementation and their recent success in designing and implementing their poverty reduction strategy. More specifically, we do not see the need for new household surveys after the five conducted between 1987 and 1995. Indeed, the two poverty profiles produced in 1987/88 and 1995/96 should suffice.

Moreover, for a country that has demonstrated ownership and success in implementing its poverty reduction strategy, there should be no need to wait for implementation of the PRSP for at least one year as suggested in the staff paper before reaching the completion point. Instead of consolidating and pushing forward the authorities' strategy, this course of action will only delay acceleration of implementation of the poverty reduction program.

Some monitoring aspects of the implementation of the poverty reduction program also need to be clarified. For example, while fighting AIDS is a very important objective, it does not seem reasonable to include the maintenance of the HIV prevalence at its level of 1999 as a condition for Mauritania to reach the completion point. The authorities' performance should be assessed on outcomes only to the extent that the link between policies and the outcome can be easily identified and monitored. I do not believe that HIV prevalence can lend itself to such a scrutiny over a short period of time.

In view of the above, we support a shorter interim period. We are also encouraged by Mr. Barro Chambrier's indication that the authorities "intend to have the completion point triggered sooner than later by the successful implementation of a set of pre-defined reform measures under the PRGF."

Extending his remarks, Mr. Daïri said that, as the case of Mauritania was one of the first that the Board was discussing under the enhanced HIPC Initiative, it was important to pay attention to the message that the Board would be conveying. If the Board applied drastic conditions in terms of the length of the interim period to Mauritania, which had had a good track record in policy implementation and fighting poverty, that might give the wrong signal.

Mr. Harinowo and Mr. Peh submitted the following statement:

We commend the Mauritanian authorities for the recent improvement in macroeconomic performance, as evidenced by the rise in annual real growth rate and decline in inflation during 1993–98. Considerable progress has also been achieved on the structural front, reflected in the overall increase in economic efficiency and productivity. We are in agreement with the program objectives for 1999–2002 and welcome the focus on the attainment of macroeconomic stability, further spending in social sectors and infrastructure, and the reduction in debt burden.

The series of pre-defined reform measures for the triggering of completion point are challenging. While some of the objectives listed in Box 7 may be rather ambitious, we believe that the good track record achieved by Mauritania points to the authorities' ability and capacity to meet the targets. As mentioned in Mr. Chambrier's comprehensive preliminary statement, the authorities are confident of the successful implementation of the program package as discussed in their memorandum. Nevertheless, we do agree with Mr. Daïri that it may not be necessary or desirable to wait for the implementation of the PRSP for at least a year before reaching the completion point under the HIPC Initiative. While we look forward to the authorities' preparation and implementation of the PRSP, debt relief will provide the necessary impetus for the successful implementation of the program. We welcome the elaboration by the authorities on the main steps and timetable leading to the production of the PRSP, as given in Appendix IV. Mr. Milleron and other Directors have raised the interesting point on the maintenance of HIV prevalence rate as one of the indicators. While the importance of AIDS prevention cannot be overemphasized, we are of the view that the problem is complex and would require a strategy entailing more than poverty reduction measures. More generally, we would appreciate it if the staff could broadly explain the basis on which the objectives under social sector and poverty reduction in Box 7 were set.

As mentioned by Mr. Chambrier, Mauritania's vulnerability to external shocks remains high given its heavy reliance on two main export products, namely fish and iron ore. The deterioration in the terms of trade, precipitated by the recent crisis of the fisheries sector, is evident of such weakness and points to the need for diversification of its exports. While the delivery of debt relief by itself will not significantly reduce the vulnerability of the economy to shocks, the implementation of the series of structural reform measures in the program will go a long way in building the foundation for strong and sustainable growth. We therefore support the proposed decision and wish the authorities success in their reform efforts.

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

In terms of Mauritania's recent efforts under the program, a firm stance on fiscal consolidation and structural reforms contributed to satisfactory economic performance during 1999, resulting in higher growth. Real GDP growth could reach about 4.7 percent in the 12-month cycle ahead;

average annual inflation is down to four percent; the fiscal surplus may exceed the original target; the external current deficit declined by three percentage points to 8.3 percent of GDP; and the exchange rate stands at 203 ougiyas per dollar, with a spread between the interbank and market rate of 6 percent. Hence the program remains on track.

On the basis of preliminary data and information submitted by the authorities, it would appear that the quantitative performance criteria for December have been met. However, that is to be confirmed by a staff mission next week, and the final data on the execution of the structural reforms included in the matrix, which is proceeding according to schedule. All but one structural performance criteria established under the program for July–December 1999 have been met. The missed criteria owed to some procedural delays, fully attributable with the successful bidder, and the sale will not take place in February but in April 2000.

On the benchmarks, progress has been made with the replacement of the discount window for treasury securities with the purchase facility, which should be produced in February. The delay is justified by the fact that the needed Fund technical assistance will only take place in February 2000. Nevertheless, both measures will be completed prior to the conclusion of the first review of the PRGF.

Finally, some Directors expressed concern that the debt ratios will remain too high at the completion point and thereafter. While the total amount of assistance reported in Table 8 is correct, there was a problem with the software that has now been resolved, which meant that the net present value of debt in 2002 did not fully reflect the amount of assistance delivered. In fact, if the completion point were to take place in mid-2002, the debt ratios would stand below target. The corrected Table 8 will be issued as soon as possible.

The staff representative from the Policy Development and Review Department said the draft decision proposed there be a determination that Mauritania had reached the decision point under the Initiative, and that the net present value of debt-to-exports target be 137 percent, consistent with the debt-to-revenue target of 250 percent.

The draft decision did not provide for interim assistance because, under the terms of the PRGF/HIPC Trust instrument that the Board had approved the previous week, the disbursement of all HIPC Initiative assistance, including interim assistance, required satisfactory assurances regarding the exceptional assistance to be provided by Mauritania's other creditors, the staff representative explained. Saudi Arabia had agreed in principle to take action on Mauritania's claim as an IDA-only country, and the staff was actively seeking such assurances from Mauritania's other major creditors. When those assurances were received, hopefully within the following few weeks, the staff would propose that the Board approve the disbursement of interim assistance amounting to 50 percent of the debt service falling due to the Fund from the decision to the completion point, as outlined in the HIPC Initiative document.

There had been general concern about the issue of participation by non-Paris Club official bilateral creditors, the staff representative noted. There would be a discussion of that more general issue on the basis of a paper that the staff was preparing.

Mr. Shaalan made the following statement:

> We welcome this opportunity to discuss the enhanced HIPC Initiative decision point document for Mauritania and we support the staff analysis regarding eligibility for debt relief under the enhanced HIPC Initiative and the proposed timing of the decision point, namely today. A floating completion point to be triggered by the successful implementation of a set of pre-defined reform measures is also agreeable to us. However, we would like to offer some comments on the measures and objectives set to reach the completion point under the enhanced initiative as outlined in Box 7 of the document.
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> The discussion on the decision point under the original HIPC Initiative should have taken place around six months ago. However, the board agreed to a postponement provided that this did not penalize the country. In this connection, it is also worth recalling that during the discussion on the preliminary HIPC Initiative document in January 1999, some chairs expressed a preference for an earlier completion point than was recommended by the staff in the document, which was three years after the decision point. That was based on the good track record established at that point in time which also continued since, as evidenced by both the staff paper and Mr. Barro Chambrier's preliminary statement. These considerations suggest that the date for Mauritania's decision point should have been in July 1999, with the possibility of reaching the completion point before mid 2002.
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> Accordingly, we are of the view that Mauritania should qualify for the flexible treatment that executive directors supported for countries that have reached their decision points. Here, let me quote from page 4 of the Concluding Remarks by the Chairman of the relevant board discussion on Poverty Reduction Strategy Paper—Buff/99/154: "... I sense that the majority of the Board favored early decision points under the enhanced Initiative for retroactive cases, depending on performance, with the timing of completion points decided on a case-by-case basis linked to the adoption of an Interim PRSP, the degree to which the PRSP is participatory, and overall progress in poverty reduction and economic performance." While Mauritania is benefiting from an early decision point under the enhanced Initiative, we are a bit surprised that not only are the authorities expected to have a full fledged PRSP in place, but also that a track record of successful implementation for at least one year is required for reaching a completion point. This does not seem to be in accord with the spirit of the Board agreement, particularly in view of

the progress made in stabilizing and reforming the economy and the successful implementation of reform measures in the social sectors which led to a marked improvement in social indicators.

Regarding the requirement to improve access and survival rate in primary and secondary education and to improve the health status, we like Mr. Milleron and other directors would like to see more emphasis placed on the feasibility of attaining the set objectives. As a general principle, it is important that the authorities not be held responsible for outcomes that are beyond their control. While no one will disagree that reducing the incidence of HIV is a laudable objective, I was shocked—to use a mild word—to see that the country needs to attain a certain level of infections to qualify for the completion point. This is, to say the least, absurd.

We share the staff's views regarding the macroeconomic and structural conditions to reach the completion point. Maintaining macroeconomic stability and pushing further ahead with structural reforms are of paramount importance not only to reap the benefits of debt relief under the enhanced HIPC Initiative but also to ensure the prevalence of an environment conducive to high and sustainable growth. This is underscored by the assertion in the staff paper that almost all gains in poverty reduction in Mauritania between 1990 and 1996 came from economic growth.

Mr. Rustomjee associated himself with Mr. Shaalan's comments on the issues of AIDS and of allowing maximum flexibility in the decision as to when the completion point would be reached.

Mr. Daïri also associated himself with Mr. Shaalan's comments. Regarding interim assistance, when the staff had proposed that the Board approve the disbursement of interim assistance amounting to 50 percent of the debt service falling due to the Fund from the decision to the completion point, the question was whether the period to the completion point would be seen as starting that day or the previous summer, when the decision point was supposed to have been reached.

Mr. Ioannou made the following statement:

Let me thank the staff for its report and Mr. Barro Chambrier for his comprehensive statement. The staff report highlights Mauritania's efforts in restructuring its economy and addressing its poor social conditions. We broadly share the staff's assessment, and support the authorities' request for a decision point under the enhanced HIPC Initiative.

Having said this, I am slightly uncomfortable with the fact that poverty reduction is treated in the decision point document simply as a component of the overall program and not as an integral element of the program from which all other actions are derived. Notwithstanding the fact that Mauritania might be exempted from the preparation of an Interim PRSP, I feel that the decision point document should have been attuned to the spirit of poverty elimination. For example, the preparation of a full, participatory PRSP is considered as one more condition for reaching the completion point, together with the reform of the foreign exchange instruments, the privatization of Air Mauritania, and the maintenance of the HIV prevalence rate at 1998 levels. On this point, I share the comments made by Mr. Milleron.

Regarding the conditions required for the completion point, I have some reservations about whether those can be adequately defined at this stage, given that the participation process has just begun and meetings with civil society only started in December. Without knowing the outcome of the consultative process, it would be difficult to specify in advance the conditions for a completion point.

Given the timetable envisaged for the completion point in 2002 and for the preparation of the full PRSP at the end of 2000, I wonder why the staff could not bring the decision point document to the Board later this year, at the time of the submission of the PRSP. That would provide the Board with a clearer view of the poverty situation and the authorities with a sufficient amount of time to implement the PRSP before the completion point is reached. The staff's comments would be appreciated.

Despite our reservations, which are more a matter of principle, we feel that the authorities should not be penalized for the introduction of our new approach to poverty reduction, particularly given that under the original framework Mauritania was in a position to reach the decision point last year.

Moreover, the timing of the completion point should not be based on any kind of pre-assigned track record. In this regard, the term "at least one year," which is used by the staff to specify the needed minimum duration of implementation of the PRSP, may contradict the nature of the floating completion point.

On the issue of debt sustainability, we are concerned that the provision of debt relief under the enhanced HIPC Initiative will not attain the targets envisaged under the framework owing, in part, to export fluctuations. This highlights the importance of adopting measures to ensure that the export base is widened and the economy is diversified, so as to avoid fluctuations as well as trade shocks.

On the issue of the passive debt, I wonder under what conditions would authorities activate their claims. Could the staff also tell the Board the size of the passive debt?

Regarding some of the activities intended to generate income for the poor, particularly promotional activities carried out by low-income households and the direction of investment to poorer areas, does the staff view favorably policies for the poor in sectors that are uncompetitive or of little value-added? Would it not be preferable to have policies that send the appropriate signals and incentives for the poor to change behavior and encourage efficiency and labor mobility? The staff's comments on that would be appreciated.

With these remarks, we wish the authorities every success.

Mr. Alosaimi made the following statement:

I commend the Mauritanian authorities for their continued economic adjustment and reform over the last few years. Their sustained efforts have resulted in reduced distortions, enhanced efficiency, and improved macroeconomic performance. However, Mauritania continues to face challenges in view of the economy's external vulnerability and excessive debt burden. Therefore, it is crucial for the authorities to persevere with macroeconomic adjustment and structural reform. Substantial financial support form the international community is also still needed.

I support the staff's recommendation regarding Mauritania's eligibility for debt relief under the enhanced HIPC Initiative. I also endorse the suggested volume and manner of assistance under the enhanced HIPC Initiative.

The authorities' good track record has demonstrated their ability to implement ambitious adjustments and reforms. In this regard, in July 1999, the Board agreed with the staff's proposal to defer the presentation to the Board of a final HIPC Initiative decision point document for Mauritania until after the approval of the enhanced HIPC Initiative framework. Thus, I agree with others that the track record for the second stage leading to the completion point for Mauritania should start from July. In this regard, like Mr. Daïri and others, I support a shorter interim period. While the measures and objectives detailed in Box 7 are worthy, I share the concerns of Mr. Milleron, Mr. Morais, and Mr. Shaalan regarding the realism of achieving some of these objectives.

Mr. Singh made the following statement:

Like previous speakers, we welcome today's discussion. In view of Mauritania's relatively good track record in carrying through adjustment policies and reforms, we do support the country's eligibility for assistance under the enhanced HIPC Initiative and the approval of the decision point today.

We also agree with the proposed amount of debt relief and with the way this assistance will be provided. We look forward therefore to the staff's proposal in the near future for the Fund to provide interim assistance and we stand ready to support it.

Concerning the conditions for the floating completion point, we broadly support the macroeconomic and structural measures, as mentioned in Box 7 of the document. In the banking area, we would like to stress the importance of the banking sector reform, since its oligopolistic structure and its strong links with some commercial groups could hinder the emergence of a sound banking system. The latter will be a key element to attract more foreign direct investment.

With respect to the conditions related to the social sector and poverty reduction, as well as to the PRSP, we would be more cautious however. We fully agree that it is important to be able to assess the authorities' efforts and we support the staff's proposal to require that the PRSP, prepared through a broad-based participatory process, be successfully implemented for a year.

But for the other objectives, we wonder whether they are at the right place. First, we share Mr. Milleron's opinion on the appropriateness of the HIV criterion. The HIV prevalence rate is clearly not under the authorities' control. More generally, as Mr. Ioannou already pointed out, we think that the objectives of the PRSP should be defined and agreed upon during the consultative process and defining here a set of objectives may give the impression that we are prejudging the results of this process or even bypassing the process. We would be interested to hear the staff's comments on this point.

Concerning the financing of the debt relief and the participation of all creditors, we note that non-Paris Club creditors represent more than a third of Mauritania's external debt. In this respect, we would appreciate it if the staff could inform us on the current state of discussions with Mauritania's non-Paris Club creditors.

Finally, I would like to make just two comments on the economic scenario. First, we wonder whether the GDP growth rate assumed in the DSA is not a little too optimistic. A GDP growth rate of more than 5 percent in average until 2017 seems to be optimistic in comparison to what Mauritania was able to achieve in the past.

Second, regarding the fishing industry, in view of the increasing share of fishing royalties in non-tax revenue (80 percent in 1998; 40 percent in 1995), we wonder if this level could be sustained in the future, especially considering that the problem of the control of these resources is not fully resolved. There seems also to be a contradiction between the aim of increasing exports, on the one hand, and the desire to achieve a sustainable, meaning lower, fishing rate, on the other hand. The staff's comments on these points would be welcome.

To conclude, let me commend the Mauritanian authorities for having reached the decision point and wish them success in the implementation of their economic agenda.

Mr. Sobel made the following statement:

We thank the Mauritanian team for its fine work in helping the authorities put together a strong package of proposals for Mauritania to reach the floating completion point and furthering Mauritania's engagement of civil society. We are in broad agreement with the recommended course.

On a procedural note, though, the decision point document includes a good poverty reduction matrix. But we were surprised by the absence of an Interim PRSP as the Concluding Remarks on operational issues on PRSPs stated that while, in principle, countries seeking assistance under the HIPC Initiative should have a PRSP in place at the decision point, "Directors noted that this could unduly delay assistance for early cases. In these early cases, they agreed that a decision point can be reached with an Interim PRSP in place."

Let us turn to the six reform areas for triggering the completion point.

First, macroeconomic stability. Mauritania has had a commendably consistent track record on promoting macroeconomic discipline this decade. Growth has been steady, inflation low, and fiscal discipline maintained.

But we felt that the staff analysis on pages 5–7 was a bit rosy. The IFIs have been extensively involved in Mauritania since the mid-1980s.

The paper somewhat understandably focuses, though, on the record since 1993. But Box 1 does so by comparing the 1993–1998 period with 1990–1992 when Mauritania faced armed conflict and internal ethnic strife.

Also, despite solid output gains, population growth has been high and real per capita incomes have risen only at around 1.5 percent per annum this decade. Surely successful development involves a "catch-up" process with more advanced countries.

Hence, we welcome the macroeconomic objectives of the program, but the aims—though realistic—are modest. We hope the reforms envisaged will create a durable basis for robust growth that translates into benefits for all of Mauritania's people.

Second, tax reform and governance. The Board discussed Mauritania's fiscal strategy at length half a year ago, and we will simply indicate that the staff's proposed approach is sensible and that it is critical to avoid exemptions and a lack of uniformity in tax rates.

Also, we welcome the creation of the independent accounting agency and urge further steps to enhance fiscal transparency. Some analysts have told us that while the budget is published, budget line items do not sum up to spending. Also, we wonder if a Public Expenditure Review might be useful. Could the staff comment on this.

Third, we strongly welcome and endorse the objectives for the foreign exchange market.

Liberalization is a prerequisite for healthy functioning markets. Mauritania is making good progress on trade liberalization and indeed, we would have welcomed the achievement of WAEMU tariff rates as a trade liberalization target.

The exchange system is also improving. But for years, report after report has raised fundamental questions about the exchange market, despite Fund support for well over a decade.

When I joined the Board a few years ago, the Board was told Mauritania's exchange market had been unified and liberalized. However, I can say today, as I said then, that the existence of two markets with significant spreads of up to 10 percent, external arrears, and heavy central bank involvement suggests otherwise to me. The staff should continue to bear down so a truly unified and liberalized foreign exchange system emerges. Would it not be sensible to include a truly unified and liberalized exchange system as a monitorable target for Mauritania to achieve by the completion point.

Fourth, the banking system. If there is one word one always hears used to describe the banking system, it is "oligopolistic." Indeed, one surmises that the oligopolistic nature of the banking system may have much to do with the problems in the foreign exchange market.

Lending rates are on the order of 30 percent, further suggesting that the banking system is uncompetitive and that high real interest rates stifle credit flows to worthy borrowers.

We thus welcome the heavy focus in the program on increasing competition in the banking system and ensuring banks comply with prudential ratios. It is regrettable that efforts to date to encourage commercial banks to meet large borrower lending limits have not been met.

Also, we have heard that the Central Bank's reserve requirement ratio legislation prevents NGOs from engaging in micro-finance lending. Could the staff comment?

Fifth, on privatization, we welcome the ambition of the program objectives and the inclusion of so many key parastatals under the program. We do continue to wonder though if privatization is a good thing for parastatals and economic performance in general, why is privatization not a good thing for SNIM?

Sixth, social sector and poverty reduction.

Regarding all of the specific economic and social indicators, that is a subject better handled on the other side of 19th Street.

But my authorities were concerned that while Box 7 was helpful in trying to demonstrate monitorable targets, it is hard to measure the targets because baseline figures were not furnished. They are also interested in knowing why some of the expected results in Appendix 3 were not included as triggers for the completion point. Also, we agree with Mr. Milleron's observations on Box 7 regarding the health criterion on maintaining HIV prevalence rate.

We welcome the helpful role played by the Commissariat, the efforts to increase social spending in recent years, and the prospects for further boosts in poverty reduction spending. But it is, of course, critical to spend these resources efficiently and perhaps the staff could comment on the strengths and weaknesses in this area.

Box 4 was most helpful. But it highlights that social spending does not increase in line with the additional savings on debt service, whereas this is a fundamental goal of enhanced HIPC Initiative support. It is also critical that there be a transparent procedure to track social spending against debt relief. The staff's comments on these points would be appreciated.

In terms of the engagement of civil society, we welcome the round tables held in December and the World Bank's town hall meeting. Could the staff elaborate on the discussion and results of the meetings. We also look forward to the staff's further intensive engagement of civil society this year as work on the PRSP progresses.

We hope that the HIPC Initiative process will itself raise the standard of communication between civil society and government. We did wonder if the participatory process was able to encompass the rural sector where extreme poverty is concentrated.

Finally, we look forward to the PRSP around end-2000 so that the delivery of debt relief can be better tailored to Mauritania's social spending needs. We noted that the completion point is assumed in mid-2002 and while we recognize that assumptions are needed for calculations, it goes without saying that this is merely an assumption and what is truly key is that Mauritania firmly implement the program and achieve all of its aims in order to reach the floating completion point.

Mr. Pickford made the following statement:

I am pleased to see the case of Mauritania come before the Board. This is the first non-retroactive case to reach the decision point under the enhanced HIPC Initiative. Given the history of Mauritania and the decision to delay the decision point under the original HIPC framework—which, on balance, was the right thing to do—it is important to be alert and sympathetic to the points made by Mr. Shaalan in terms of making sure that Mauritania is not worse off as a result of that treatment.

I agree with most of the points in the paper on eligibility for debt relief, the timing of the decision point, delivery of assistance, and creditor participation, and would like to concentrate on two issues: the conditions for and timing of the completion point.

On the conditions, let me first talk about the PRSP itself. A proper PRSP is a key condition for the completion point, and it must be developed thoroughly and with care. Indeed, rather than concentrating on detailed conditionality at this stage, the vital task is to put resources and effort into producing a full PRSP. In this context, I wonder whether the timetable for producing the PRSP might be slightly too rushed. We would expect a full PRSP to contain more poverty analysis than appears in the current document. Although some of these issues are more for the World Bank to consider, it is important to look at social obstacles or opportunities for tackling poverty and ways to generate income and employment opportunities for the poor.

In addition, the authorities will need to carry out discussions on trade-offs arising from the analysis of policy options, which is currently planned for October 2000. There is also a need for participatory poverty assessments. Taking all of that into account, we wonder whether the 12-month period that is assumed for the preparation of the PRSP might not be too short. On the other hand, Mr. Shaalan has made compelling points about the timing of completion point, which in our view should depend on the progress made in meeting the conditions. As Mr. Sobel said, the key is to actually achieve the objectives, thus I am slightly concerned about the rigid timetable proposed in the decision point document.

On the other conditions for meeting the completion point, I agree with many of the comments made by other Directors about Box 7. My concerns which I also raised at the Bank Board mostly deal with Section B in that box. I worry generally that the conditions in section B are not necessarily appropriate. The completion point should depend on the country meeting and achieving relatively short-term intermediate targets that are measurable, defined, and under the government's control. Directors have mentioned that the AIDS target does not meet those criteria. However, Number 2, the enhancement of economic and social conditions of the poor, also falls within that category because of the possibility of exogenous shocks. The targets on enrollment and vaccination rates are much more appropriate, because they are measurable and deliverable.

There is a need to spend more time on the proposed decision. I would be unhappy with including a direct reference to Box 7, and I would also prefer not to be as specific in the reference to "at least a one-year track record in implementing the poverty reduction strategy."

Mr. Sdralevich made the following statement:

Let me at the outset express our appreciation for the results obtained by the authorities of Mauritania in economic stabilization, structural reform, and fight against poverty. We support eligibility for the enhanced HIPC Initiative and the approval of the decision point today as a recognition of their efforts. We have just a few remarks.

First, we agree with the features of the debt relief and interim assistance proposed by the staff, and in particular we deem the assumptions regarding the completion point timetable to be realistic. The measures and objectives envisaged are ambitious and require all the authorities' efforts, as well as considerable time to implement. Given the central role of the poverty reduction strategy, we agree with the requirements of the 1-year implementation of the PRSP and of its endorsement by the boards of the Bank and the Fund.

Second, we share some of Mr. Milleron and other Chairs' concern regarding the social and health objectives included among the conditions for the floating completion point. Some indicators may not fully be under the authorities' control. In such cases, intermediate objectives should have been preferred.

Third, beyond the usual role in carefully monitoring the realization of the macroeconomic program, the Fund will also have to pay special attention to the resolution of key structural issues, including the rationalization and liberalization of the exchange rate market and the completion of the reform of the banking sector, which have strong implications for the strengthening of the economy and therefore for the reduction of poverty.

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

Mr. Merz made the following statement:

I can be brief as we concur with the main findings of the well-elaborated staff document.

Mauritania has indeed made significant economic and social improvements over the last years. On the macroeconomic front, the country despite some setbacks and slippages has been implementing a comprehensive program of stabilization and structural reforms since 1985, reflected also in the recent encouraging economic indicators. On the social front, we welcome the improvements of social indicators. Box 1 in the staff paper demonstrates the substantial shift from defense to social expenditures during the last decade. As outlined by Mr. Chambrier in his very informative preliminary statement, the most recent draft budget for 2000 enforces this development by doubling the share of budgetary resources allocated to the poverty reduction programs and by substantial increases in health and education expenditure. However, on both the macroeconomic and the social front much more needs to be done. Mauritania remains vulnerable to exogenous shocks and the fight against poverty is still very much in its early stages.

We support Mauritania's eligibility for debt relief under the enhanced HIPC Initiative due to the fiscal criterion. We can also agree on the principle of a floating completion point and can broadly subscribe to the measures and objectives outlined in box 7 of the document. We would put emphasis on the need to achieve a market determined exchange rate as soon as possible—as mentioned by Mr. Sobel—on the need that tax exemptions will be eliminated and VAT rates will be unified and on the need that commercial banks will much better comply with the general prudential regulations, as established in the 1995 Banking Law. Furthermore, the PRSP process should be broad based and clearly focused on education and health. In this regard, we are—as in other cases—a little bit worried that the most recent data on social indicators cover only the period up to 1996.

Regarding the debt sustainability analysis and the assistance under the enhanced HIPC Initiative, we have shared the surprise expressed by Mr. Milleron that the staff presents debt ratios after enhanced HIPC Initiative assistance which are largely above the targets at the completion point. But I take note of the clarification made by the staff at the beginning of this meeting and we are looking forward for the revised table.

Mr. Liu made the following statement:

I thank the staff for a well-prepared paper and Mr. Barro Chambrier for his helpful statement. The authorities should be commended for their efforts to improve the country's macroeconomic environment. Like other Directors, I support Mauritania's eligibility for debt relief under the enhanced HIPC Initiative, and agree that July 1999 should be the starting point for the track record and the second stage. I also support the program objectives for 1999 to 2002, and hope that further efforts are being made to alleviate the country's vulnerability to external shocks.

I would like to associate myself with Mr. Daïri's view that there may be no need to wait for the PRSP to be implemented for at least one year before reaching the completion point under the HIPC Initiative.

With these remarks, I wish the authorities every success.

Mr. Fenton made the following statement:

We consider Mauritania to be eligible for debt relief under the enhanced HIPC Initiative and support the use of the fiscal criterion for the calculation. We agree with the chairs that indicated that July 1999 should be the starting point for the track record under the second stage. And we share the concerns about Box 7 expressed by Mr. Milleron, Mr. Pickford and others. Finally, we wish to associate ourselves with Mr. Sobel's remarks on the participation of civil society in the development of the poverty reduction strategy paper and its implementation.

Mr. Jacoby made the following statement:

During the last decade the Mauritanian authorities have been quite successful in implementing their macroeconomic adjustment and stabilization policies. Inflation has been subdued, the fiscal position has been consolidated, and important structural reforms have been introduced. Despite these successes, however, Mauritania continues to suffer from external vulnerability, high unemployment, and widespread poverty. A poor country even by Sub-Saharan standards, Mauritania also has an unsustainable burden of external debt. We therefore welcome today's discussion on Mauritania's eligibility for debt relief under the enhanced HIPC Initiative.

Mauritania obviously meets the criteria for assistance under the enhanced HIPC Initiative. Whether based on the NPV debt-to-exports ratio, or the NPV debt-to-revenue ratio used for assistance through the fiscal window, Mauritania's external debt position would remain unsustainable even after full application of traditional debt relief mechanisms. For this reason I fully support the request of the Mauritanian authorities to reach the final decision point. I understand from what Mr. Booth said, that presently no satisfactory assurances from Mauritania's other creditors are available. I would be interested in the relative size of these assurances compared to the total amount of assistance.

As already stated during the PRGF discussion, I can agree to stipulate that the track record for the second stage began with the new PRGF arrangement. I further agree with the idea of setting a floating completion point, under which Mauritania would be deemed to have reached its completion point once it has implemented the pre-defined set of key policy reforms summarized in Box 7 of the staff report. Fulfillment of these preconditions is important as confirming that Mauritania's key structural reforms are well on track and that its macroeconomic position is stable. Even more important, the interim period will provide time for the participatory process to expand and reach all concerned layers of society.

At the same time I must deplore omission of a rural development benchmark from the aforementioned preconditions, given the importance of the agricultural sector for food security and rural poverty. Concerning the banking sector reforms, I wonder whether in addition to the credit concentration ratios, the conditionality should not have included some provision for reducing the enormous spread between lending and deposit rates. The oligopolistic nature of the banking sector represents an obvious obstacle to private-sector-led growth. And finally, I support Mr. Milleron's view on the HIV condition.

On the amount of assistance, I agree with the staff that the debt relief must make it possible for Mauritania to reach a sustainable level of external debt as defined by the fiscal/openness criterion. I was puzzled to read, in paragraph 67 of the staff report, that the planned assistance will not suffice to meet the debt sustainability target at the completion point. This completely contradicts the proposed decision. The staff's comments would be welcome. As regards the actual disbursement of the assistance, I assume that it will accomplished in accordance with section III 3(f), 5(a) and 5(b). Could the staff explain why the proposed decision does not include any reference to these paragraphs?

In conclusion, Mr. Chairman, let me stress that I share the staff's concerns about the uncertainty of the balance-of-payments projections. This perfectly underlines the Mauritania's external vulnerability, and the need to diversify the economy to enable Mauritania eventually to achieve broad-based sustainable growth and true external viability.

Mr. Elkjaer made the following statement:

I also support the Initiative, and agree with the proposed timing of the decision point. I would, however, expect and prefer to have had a full PRSP at this point.

I have the same concern and question as Mr. Jacoby on the issue of satisfactory assurances from other bilateral creditors, and what that means for the Fund's commitment to provide debt relief.

The staff representative from the African Department reported that the total amount of assistance to be provided Mauritania was $622 million, while the share of interim relief was 14 percent of that, about $85 million. The World Bank would provide about $13 million out of the total of its own total assistance of $100 million, or 13 percent, as interim assistance. The Fund would provide about $17 million out of its own total assistance of $47 million, or 36 percent. The World Bank would provide debt relief for 70 percent of the debt due to the Bank from the present date until 2019, while the Fund would provide relief for 50 percent of the debt due from the present date until about 2002, depending on the completion point, and 45 percent of the debt falling due thereafter. Multilateral creditors were not expected to provide any interim assistance, but the staff assumed that they would provide 60 to 100 percent of debt relief after the completion point. The staff assumed that there would be a Paris Club meeting where there would be a decision about providing flow relief on Naples terms. The difference between a Naples flow and a Cologne flow would be what was called an "interim stock-of-debt operation" at the time of the completion point that would provide $22 million out of $137 million, or 16 percent of the total. There were expected to be similar arrangements for the non-Paris Club debt, which amounted to $33 million out of $137 million, 26 percent.

Regarding the concessionality of Mauritania's new debt, it was assumed there would be only highly concessional terms for the Fund's ten-year maturity, and a 0.5 percent interest rate for everything else under IDA terms, the staff representative reported. With 37-years maturity and 7.5 years grace period and a 0.75 percent interest rate, that would be about 70 percent concessional.

The total amount of the passive debt in 1998 in nominal terms was $493 million, or $479 million in NPV terms, the staff representative explained. Moreover, on the issue of how the debt would be treated, the staff had informed the Board in the preliminary document that that debt had not been claimed for more than ten years, and that letters would be sent to all of the creditors asking when they intended to claim the debt. So far, the debt had not been claimed, and the staff did not expect that the situation was going to change. However, in the event that creditors activated their claims, one had to determine what the terms of that debt would be. Even if a Naples stock-of-debt operation were applied, which would reduce the amounts to a third, it would still not be possible to include that debt directly in the total stock. There would have to be bilateral negotiations to make sure that there were comparable terms, but the staff did not expect that to happen. The Fund had taken the correct steps in contacting the creditors, and it was the choice of the creditors not to activate their claims.

Mr. Daïri proposed that in the preliminary document, instead of asking creditors to confirm their claims they should be asked to consolidate their claims and indicate whether the passive debt was included in their calculations. Otherwise the debt would not be treated properly. Even though a creditor had not responded to the Fund, its claim would not disappear, and there would continue to be a debt overhang.

The staff representative from the African Department said that Mauritania had not prepared an Interim PRSP because it was a transition case. In the documents presented in December 1999 on operational issues regarding the PRSP and PRGF, a footnote of paragraph 47 in the paper on PRSP operational issues stated that in transition cases, including Uganda and Mauritania, there would not be an Interim PRSP requirement because the process of preparing poverty reduction strategies was already quite advanced. In the case of Mauritania, its poverty reduction strategy had all of the elements of an Interim PRSP, including a timetable for the production of a full PRSP, and the launching of a participatory process. Thus the staff felt comfortable that all the components of an Interim PRSP were already available for the Board to review.

Mr. Sobel commented that, while he was comforted to hear that Mauritania's poverty reduction strategy was equivalent to an Interim PRSP, the summing up of the December 1999 discussion trumped the footnote that the staff was referring to.

The staff representative from the African Department remarked that the staff was surprised that the Board was discussing specific track records in terms of time vis-à-vis the conditions for the completion point, because there had been a clear choice by the authorities to wait for the introduction of the new HIPC framework, which had slightly different conditions, including the concept of floating completion points. That decision had been made because the staff and the authorities felt that the country would be better off under the new framework. In fact, the amount of assistance the country received under the original HIPC Initiative would have been about $340 million, instead of the current estimate of $622 million in NPV terms.

Regarding timing, the staff saw 2002 as an indicative point because it would be three years from the beginning of the track record and more would be achieved by then, the staff representative explained. However, the conditions could be implemented by end-2001 if Mauritania made an effort, and then completion point would float to that earlier date, which the staff would welcome.

As to the length of time that the PRSP should be implemented, page 13 of the PRGF-HIPC Trust instrument said that "In addition, the member shall prepare a PRSP and implement it for at least a year prior to reaching the completion point," the staff representative noted. In terms of the substance, Mauritania would be better off if the authorities began to upgrade their efforts to fight poverty, and learned from the process as they worked to develop a comprehensive PRSP.

Mr. Pickford agreed that the choice vis-à-vis the PRSP had to be left to the authorities. What concerned him, however, was the way in which the conditions might interact. There was no problem with an assumption of a completion point in mid-2002, and it could even be earlier if satisfactory actions could be completed by then. It was important not to be overly concerned about legalistic definitions, because the quality of the PRSP should not be compromised by trying to rush it. However, it seemed contradictory for the Board to require a year's track record in implementing the PRSP, not the Interim PRSP, from a country that had decided to take its time in elaborating it. That might penalize countries for doing a better job, and might create a perverse incentive for countries to create PRSPs too quickly.

The staff representative from the African Department reiterated that the authorities were starting from a good base. They had set up the first strategy to fight poverty in 1998, and had revised that strategy in 1999. It had been known since April 1999 that the changes to the HIPC Initiative were coming and more or less what shape and form they would take. Therefore, the staff of the World Bank had started working with the authorities—for example, in trying to find the monetary indicators—to see what kind of things would have to be in place for the PRSP. The process was not starting anew but would build on something that the authorities had been doing for a number of years and that the staff of the Bank had been working on over the past nine months.

The timetable was tight but feasible, and there could be a PRSP adequate to satisfy the Board within the period allotted, the staff representative reported. It was hoped that the PRSP would be even better one year later, when one would have learned from the mistakes of the first year, as it would be a trial and error process, and poverty was not an easy issue to solve. The staff would try to do its best in the short time available.

The triggers for the floating completion point had caused a great deal of controversy, although less from the viewpoint of the appropriateness of the macroeconomic and structural targets, the staff representative observed. The social targets had been agreed with the authorities. As to how those targets had been developed, the process had started with the numbers and targets that had been set out in the PFP in July 1999. All of those targets were attainable by end-2001 or early-2002.

The new HIPC Initiative framework placed a greater focus on outcomes, the staff representative commented. Thus, the question was not how much money was being spent on health and education, but what the country was getting from it, which allowed the staff to put some kind of benchmarks in place. It was expected that the Board would come to some judgment as to whether those targets had been met, as well as why and how.

The target on the rates of HIV infection could have been better phrased so as not to seem to require outcomes that were beyond the control of the authorities, the staff representative acknowledged. It was an important target, however, particularly in light of the recent Libreville Summit. HIV/AIDS was one of the most pressing problems facing African countries, and it had been somewhat neglected as a result of social or religious mores. The staff had tried to take into account the sensitivities of the authorities; perhaps an intermediate indicator such as "contraceptive use" would have been better, but that was not acceptable to them.

More household surveys were needed to assess what was being done, and how, to reduce poverty, the staff representative explained. That was not related to the HIPC Initiative but to the fact that Mauritania needed to know how that effort was proceeding.

The fishing royalties were split into two, the staff representative noted. There was a variable part, which was the license part, as well as a set fee, which was essentially a transfer. There was an inconsistency between the fact that they were both in the current account and the treatment of government revenue. The staff in the Fiscal Affairs Department could not accept excluding an element of government revenue simply because it was variable or uncertain, as that would mean that most countries would exclude revenue from natural resources, on which they relied heavily.

On the exchange system, there were currently two markets that were not unified, the staff representative commented. There was the interbank market, which was the official market, and a cash market, which included the foreign exchange bureaus. The five percent commission for cash transactions accounted for half of the spread that the staff had allowed. There was a direct supply of cash from the central bank to the bureaus, because sometimes the individual banks were reluctant to provide cash to the bureaus. In setting the official rate, both the official interbank rate and the rates of the bureaus were taken into account, which was why the rate had been moving. The spread had more recently been managed at six and seven percent, with the commission at between one and two percent, which the staff found perfectly acceptable. The staff agreed with Directors' comments about the obstacles of the banking system, which was something it was trying to address in the context of the program. The staff had chosen that particular benchmark because it was considered symbolic and important, in the sense of trying to break the cross ownership and lending between the banks and the groups. But the staff was doing many other things in the context of the PRSP and the PRGF.

Privatization of Mauritel was good, but because of its oligarchical structure it was important to be careful who bought the shares, the staff representative remarked. It would have to be foreign interests, but it was not clear whether the government agreed with that. It was a well-run, efficient company that provided revenue to the budget, and was audited. Therefore, it was difficult to see why it was so important to privatize the company. The staff's only concern was the question of taxation, and it was addressing that in the context of the program, by eliminating its exemptions on the value-added tax.

Mr. Daïri said that he was surprised by the reaction of the Fiscal Affairs Department regarding the fishing royalties. There had often been similar presentations of fiscal balances, including or excluding official transfers. It could well have been taken as an official transfer in the budget and excluded from above the line, and the calculation would have been on that basis.

The staff representative from the African Department responded that because it was government revenue, it was classified as a transfer, although it was not a transfer in the sense of being a grant or unrequited transfer from abroad. Another issue was whether it was revenue that could disappear, like other transfers. Perhaps if the fishing agreement were not renewed, the government would get taxation from that source. It was unrealistic to assume that the revenue would disappear. The staff had a concern about that; some countries chose not to renew the agreement because they thought that they would be better off without it.

The staff representative from the World Bank noted that the PRSP not having been drawn up did not mean that there had not been long-standing discussions and work between the authorities and the MFIs, as well as bilateral talks. Some of the material highlighted in the boxes presented in the document showed there had been a long history of poverty analyses, including the poverty strategy presented to the March 1998 consultative group meeting. Therefore, the PRSP was a continuation, deepening the effect of the determinants with public expenditure as well as public policy.

The Bank had been involved for an extended period of time in some of the social sectors, the staff representative stated. There had been a number of education sector projects, and the staff was currently implementing, with the authorities' assistance and the participation of the development partners, a health sector investment program. In those sectors, the Bank had a long-standing history.

The staff had put in summary form in the annex of the staff paper the envisaged PRSP road map, the staff representative noted. A workshop in December, 1999 set up by the authorities, had brought together local and regional elected officials, 18 non-governmental agencies, trade unions, the press, and the donor community. A web-page had been created where Directors could access all of the speeches and interventions of the participants. The Bank staff had also participated in discussions at a town hall meeting on what the poverty profile would look like and what kind of process would be useful. That meeting had also included a broad range of participants from the religious community, NGOs, the press, and the donor community. The Bank staff would continue to encourage and assist the authorities, as appropriate, in conducting an open and participatory PRSP process.

Regarding the content and timing of Box 7, the objectives and goals had been set by the authorities in a number of ongoing operations, including in the education and health sectors, the staff representative commented. Those were the authorities' targets and they were included in the Bank's lending operations with Mauritania, thus there was no conditionality in that sense.

The wording on the HIV issue had been unfortunate, the staff representative acknowledged. The word should be to "cap" the HIV rate rather than "maintain" it. The high sero-positivity level was a development problem, as well as an economic one, with consequences for health training and other areas. The government, with the support of its partners, was putting in place the kind of instrument that, from experience, should be effective in containing the epidemic. That included information and education campaigns, not just in the health sector but in other areas such as education, mining, transportation, and the military. Those were all areas where the probability of sero-positivity was high. Thus it was important to put in place policies, such as on the marketing of condoms, that were sustainable and adequate with respect to bitherapy and tritherapy. It was also important to have a social protection program for orphans and dependents affected by the AIDS epidemic.

The staff was working with the authorities on that package of measures. If it was put in place with the rigor typical of Mauritania, it was perfectly feasible to achieve the kind of goal that had been set to contain the epidemic.

The staff would work to ensure that there was substantial progress toward achieving the country's goals and to ensure that the necessary effort had been made, the staff representative offered. Part of the exercise of the PRSP process was to ensure that appropriate adjustments were made to the effort in order to make the attainment of those objectives more likely. That was why there was a need for continued refinements to the PRSP as a management tool. That point had been summarized in one of the boxes on monitoring and evaluation, and the staff was willing to go into further detail bilaterally on the matter.

Mr. Rustomjee thanked the staff of the World Bank and Fund for their clarifications. He wondered whether the criteria for the attainment of the floating completion point was the enhancement of the economic and social conditions of the poor or the reduction in the share of the population below the poverty line? It was better to have measurable targets.

Mr. Pickford said that it was laudable to identify as a desired outcome the capping of the HIV rate and reduction of poverty. Moreover, it was important to take some time on the early cases and get the strategy to achieve those outcomes worked out, and it was probably most appropriate to have those outcomes specified in the PRSP rather than in other documents. However, it did not seem appropriate to tie the completion point to the achievement of those outcomes. It was much more acceptable to have outputs or intermediate targets that were actually deliverable. For example, in the case of HIV, it would be much more appropriate if the measure to trigger the completion point were to be that the government should put in place an effective public awareness campaign or safety nets for HIV orphans, as such steps were directly within the government's control. Those were sensible public policy measures that the government could take in order to help achieve well-defined, desired outcomes. It would be difficult to dictate to governments what they should define as their targets, and that was not what he was suggesting. However, the document should set targets that were more operational, measurable, and achievable. That would take away a certain amount of discretion and uncertainty.

Mr. Daïri said that he fully supported Mr. Pickford's point. It should be made clear that the completion point would not be conditional on particular outcomes, but rather on how the authorities strived to achieve them.

On the issue of fisheries royalties, the amount represented 7 percent of GDP, which was not insignificant, Mr. Daïri remarked. He did not consider that if the amount disappeared by end-2001, the government had means of repaying it by other revenue. Thus, not only would the amount of the assistance be reduced, but the program itself would be jeopardized, because if the authorities assessed their fishery resources by end-2001 and considered that the license should not be renewed, they would be obliged to renew it, even if that were inadvisable for preservation purposes. Therefore, the authorities would be obliged to pre-judge the result of their assessment of the fishery license renewal by end-2001.

The Acting Chairman said that Mr. Daïri's point was important, but was more related to classification and a technical issue.

Mr. Daïri commented that if the money from the license disappeared, the authorities would not be able to replace it by other revenue, which might jeopardize the program.

The staff representative from the African Department observed that there was always an element of uncertainty in most of the countries that had programs. However, in some countries, problems in the pricing of oil or iron ore would not jeopardize the program. Instead, their effect would be assessed, and the staff would take the correct measures needed to put the program back on track. That would not influence the authorities' decision as to whether to renew the agreement or not. They would do what they considered best. However, if there were a shock to revenue, measures had to be taken, although the staff did not think that that was likely.

The staff representative from the Policy Development and Review Department said that the staff regarded fishing revenues as equivalent to any other form of property income, which was also the view of the Fiscal Affairs Department. The staff was concerned about any arguments suggesting that one particular source of revenue should be excluded, because there was a danger that other countries would say that a particular source of revenue was also uncertain because it could not be guaranteed.

According to the terms of the HIPC Initiative instrument approved by the Board the previous week, the trustee retained the right to provide assistance beyond that committed by the exact wording, which had now been a finalized decision if there was a fundamental change in the economic circumstances, the staff representative noted. Clearly, if there were a major change in world fisheries, it would be up to the Board to consider whether those conditions had been met. Thus, there was a general framework that could cover that extreme eventuality.

Regarding Mr. Daïri's question about how the staff calculated interim assistance, if the Board that day made a decision to approve the decision point, the staff would calculate interim assistance from that point, the staff representative explained. Once the staff had satisfactory assurances of participation from other creditors, it would place the interim assistance in an escrow account owned by Mauritania, with an agreement on a schedule for drawdown. There was no loss to Mauritania in the fact that the staff did not backdate it, in the sense that interim assistance was an advance on the completion point assistance. The total volume of assistance that the Fund would provide was unaffected by whether it was provided by way of interim assistance or at the completion point.

On Mr. Ioannou's question about why the staff had not waited until the PRSP was ready to present the decision point, it was clear from the general framework of the enhanced HIPC Initiative that the staff should do everything possible to bring as many countries to an early decision point, meaning that they would not necessarily have PRSPs ready at that point, the staff representative explained. If there were not, the staff had to balance two conflicting objectives: to give some idea of the authorities' priorities in the area of poverty reduction through the conditions for the floating completion point, while leaving things open to be agreed in a participatory process as part of the PRSP. The staff had tried to strike a balance between the two objectives in the case of Mauritania, but it was not perfect.

As to why the staff was requiring a one-year implementation of the PRSP before the completion point, that was the general condition agreed by the Boards, and it would apply in most cases, the staff representative explained. The idea was that countries should have a PRSP and have achieved some progress in implementing it. That progress would be presented in the first annual progress report on the implementation of the PRSP. The instrument and the general discussion had provided for exceptions to that for retroactive cases. Mr. Shaalan had argued that Mauritania could be considered equivalent to the retroactive cases. However, the general consideration was that not "all" retroactive cases would "necessarily" have to meet the one-year implementation requirement—but most probably would. One good example was the case of Uganda, which the Board had discussed the previous week. It was the staff's judgment that Mauritania should prepare the PRSP and implement it for one year; and that was the wish of the authorities as well.

The Board had now seen the two cases where there would not be an Interim PRSP, and there were not expected to be any others, the staff representative noted.

Regarding the issue of tracking debt relief, the staff was anxious to do what it could, particularly given the public concern on that issue, to draw a link between the debt relief provided under the Initiative and poverty-reducing expenditure, the staff representative said. However, that issue was quite tricky, and it was difficult to translate the debt relief provided into demonstrable and clearly identifiable poverty reducing expenditure.

The decision point was an important part of the process through which the Bank and the Fund proceeded to secure satisfactory assurances, the staff representative remarked. Once the decision point was reached, the Bank and the Fund consulted with creditors in order to make sure that they would be participating in the debt relief effort. As soon as the staff had what could be considered a sufficiently critical mass of creditors, it could arrive at a judgment that the objectives of the Initiative were going to be achieved in the case of Mauritania. The staff would then come back to the Board with a decision to be taken on a lapse-of-time basis, on which the Fund could provide interim assistance.

Mr. Barro Chambrier made the following concluding statement:

> I would like to thank my colleagues for their constructive advice and support with regard to Mauritania's eligibility for debt relief under the enhanced HIPC Initiative and the final decision point. I am particularly thankful that the starting point for the track record and the second stage will be July 1999. Much flexibility was also shown with regard to the completion point. Many Directors stressed that Mauritania could be considered to be a retroactive case and that it has achieved much, as evidenced by the social

indicators. However, much remains to be done, and the objectives are ambitious.

This is a learning-by-doing process, and I welcome the clarifications brought about by the discussion and the contributions of Mr. Pickford and others. The staff will adjust to the reality of the participatory process, but it is important for the authorities to set for themselves ambitious objectives. For example, the problem of the substantial population below the poverty line can be addressed if ambitious objectives are set.

I will convey Directors' views to the authorities with regard to the tax reform and governance issues and the need to accelerate the privatization process and pursue banking system reform. The full PRSP will give more indications on the poverty reduction and social sector targets.

There was an important reference made by Mr. Sobel with regard to the functioning of the foreign exchange market. That is important and it will be at the top of the list of the authorities. It is related to the legal and political nature of the banking system, and significant progress has been achieved with the technical assistance of the Fund. There has been improvement in this domain, but it will take time to deal with all of the necessary measures.

I would like to reiterate the strong commitment of the authorities to implementing forcefully the ambitious program and their determination to achieve the targets set in the medium term and financial program in order to reach rapidly the completion point. I once again welcome the proposal to shorten the interim period. I can assure the Board that the authorities will take care to allocate the resources freed up by debt relief under the HIPC Initiative to realize the program aimed at improving the living standards of the population.

Let me thank the staff for the support and advice it has provided to my authorities.

The Acting Chairman noted that the proposed decision appeared in Supplement 1 to EBS/00/5 and asked if Directors had any amendments or corrections.

Mr. Pickford noted that a number of Directors had voiced concerns about some of the conditions for the completion point. If the country itself wanted those conditions set and if it was understood that the Board could interpret them flexibly per exogenous factors that would prevent their achievement, and that was recorded in the minutes, he could support that. However, the issue raised a general point that the Board would have to return to in other cases.

Was the reference to "at least one year" in Point 2(c) of the decision consistent with the feeling that there should be a degree of flexibility and that the completion point should be able to float, Mr. Pickford wondered? As things stood, the completion point appeared to be able to float only in one direction.

Mr. Jacoby asked, regarding Point 5 of the decision, which referred to the PRGF-HIPC Trust instrument, whether, rather than referring to paragraph 3(e), it might not be better to refer to paragraph 3(f), about the approval of the disbursement, and paragraph 5(a) and (b), about how it would be done.

The staff representative from the Policy Development and Review Department noted that in a general sense, the proposed decision had to be read in the context of the PRGF/HIPC Trust instrument. Therefore, with the reference to paragraph (3)(e), which defined the terms under which the Board authorized a disbursement, that was automatically understood to be in the context of the instrument and was subject to the conditions under 3(f). It also included paragraph 5, which actually talked about the availability of resources and was a separate discussion.

Mr. Jacoby asked whether it would be better to refer to those paragraphs in the instrument to avoid any misinterpretations of the decision.

Mr. Sdralevich asked whether the endorsement by the Boards of the World Bank and the Fund of the PRSP was implicit in the reference to Box 7.

The staff representative from the African Department said that if there was a reference to Box 7, it was implicit that the points therein were endorsed.

The staff representative from the Legal Department confirmed that the draft decision had been prepared in the context of PRGF-HIPC Trust instrument, which established a predefined set of conditions and definitions. Paragraph 1 of that instrument included a definition of the PRSP, saying that it was a paper prepared by the country concerned and broadly endorsed by the Bank and the Fund. It was not unusual to interpret that definition in the instrument as governing the terms used in the decision.

As to why paragraph 3(e) of the instrument was referred to, but not paragraph 5 or paragraph 3(f), the decision had been drafted in the context of the broader facility and was normally construed that way, the staff representative said. It was almost identical to those in previous cases, except for a few differences that reflected enhanced aspects of the instrument. The only problem was the paragraph dealing with when the assistance would be provided. Reference 3(e) said that at the completion point, the Trustee would disburse the amounts committed. Usually it was only at the completion point—or, in the case of Mauritania, at the time of the decision to provide interim assistance—that more specificity would be added to deal with the schedules for disbursement and other issues, like those covered in paragraph 5. It was up to the Board to change that format, should it decide that that was appropriate, but the current case was not in any way inconsistent with the Board's previous practice.

Mr. Elkjaer asked the staff to confirm that the decision on interim assistance would be sent out on a lapse-of-time basis.

The staff representative from the Policy Development and Review Department replied that there were two decisions. The first, which the Board was being asked to make right away, was the decision that Mauritania had effectively reached the decision point under the enhanced HIPC Initiative. The second decision, for the Fund only, would be on the disbursement of interim assistance. The staff was not in a position to recommend that to the Board yet, but hoped it could soon do so. That decision would be submitted to the Board on lapse-of-time basis, once satisfactory assurances of participation were received from other creditors. That would technically amend the decision the Board was currently making as far as the provision of interim assistance was concerned.

The Acting Chairman stated, in response to Mr. Pickford's comments, that all Directors had called for flexibility in one way or another, and it was understood that for "floating" to be a meaningful term, it had to mean that the completion point could float both ways. Given that understanding, the language in the decision should be retained.

The Acting Chairman made the following summing up:

> Directors agreed that Mauritania had established a credible track record and demonstrated generally sound performance in implementing a comprehensive program of macroeconomic, structural and social reforms, and they supported the thrust of the program for 1999–2002. They therefore supported Mauritania's eligibility for debt relief under the enhanced HIPC Initiative, and agreed that, to address fully its external debt burden, the fiscal criterion should be used to calculate the reduction of the NPV debt.
>
> Directors agreed that the decision point should be reached now, but they noted that, as Mauritania's track record would have allowed a decision point in July 1999 at the time of the approval of the first annual PRGF arrangement, the second stage to the completion point should be seen as having started at that time. In that connection, Directors supported a floating completion point, which would be triggered by the successful implementation of a set of predefined reform measures. They agreed that a fully developed PRSP should be prepared, endorsed by the Fund and IDA Boards, and successfully implemented for at least one year. Some Directors, however, expressed concern that the latter condition could lengthen the interim period between the decision and the completion point.
>
> Directors encouraged the authorities to proceed in their efforts to build up a broadly based participatory process and accelerate the preparation of the PRSP. They also underscored the need for the authorities to implement key reforms in the foreign exchange market, banking system, to complete the privatization program and improve the delivery of social services. In this context, they welcomed staff reassurance that, while the envisaged objectives of the PRSP are ambitious, they are fully achievable, given the authorities' strong commitment to implement the required measures. Nevertheless, some

Directors expressed concern that the achievement of some of the social indicators is not completely under the control of the authorities. In this respect, they suggested caution in setting these indicators to ensure that they are fully measurable. Directors agreed that, given the progress already made in developing a poverty reduction strategy and the authorities' track record of policy implementation, the conditions in the social area for meeting the completion point should be interpreted flexibly.

Directors welcomed the authorities' efforts which have contributed to reducing the incidence of poverty, from 57 percent in 1990 to about 50 percent in 1996. The authorities were encouraged to persevere in their commitment to reduce poverty and to apply effectively the resources freed by debt relief under the HIPC Initiative to this objective.

Directors endorsed the staff proposal that a decision on the Fund's commitment of interim financial assistance be approved on a lapse-of-time basis, once satisfactory assurances from creditors are received concerning their commitment of resources, as required under the PRGF-HIPC Trust Instrument.

The Executive Board took the following decision:

1. Based upon the external debt sustainability analysis for Mauritania (EBS/00/5, 1/14/00), the Fund, as Trustee (the "Trustee") of the Trust for Special PRGF Operations for the Heavily Indebted Poor Countries and Interim PRGF Subsidy Operations (the "Trust"), established by Decision No. 11436-(97/10), February 4, 1997, decides:

(i) that in accordance with Section III, paragraphs 1 and 2 of the Trust Instrument (the "Instrument"), Mauritania is eligible and qualifies for assistance under the enhanced HIPC Initiative as defined in the Instrument;

(ii) that the completion point for Mauritania will be reached on the date when the Trustee determines that:

a) Mauritania has satisfactorily implemented the policy reforms described in Section IV and Box 7 of EBS/00/5;

b) Mauritania has a stable macroeconomic position and has kept on track with its Fund-supported program; and

c) Mauritania has prepared a Poverty Reduction Strategy Paper and satisfactorily implemented its poverty reduction strategy for at least one year;

(iii) that the external debt sustainability target for Mauritania is 137 percent for the present value of debt-to-exports ratio, which results in a reduction of the present value of debt-to-revenue ratio to 250 percent;

(iv) that, in accordance with Section III, paragraphs 3(a) and 3(b) of the Instrument, the equivalent of SDR 34.80 million will be made available by the Trustee to Mauritania in the form of a grant to permit a reduction in the net present value of the debt owed by Mauritania to the Fund, subject to satisfactory assurances regarding the exceptional assistance to be provided under the enhanced HIPC Initiative by Mauritania's other creditors; and

(v) that, in accordance with Section III, paragraph 3(e) of the Instrument, the Trustee shall disburse the amount of assistance committed to Mauritania under paragraph (iv) of this decision at the completion point. (EBS/00/5, Sup. 1, 2/2/00)

Decision No. 12135-(00/11), adopted
February 2, 2000

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/00/10 (1/31/00) and EBM/00/11 (2/2/00).

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director, by Advisors to Executive Director, and by an Assistant to Executive Director as set forth in EBAM/00/15 (1/31/00) is approved.

6. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/00/11 (1/31/00) is approved.

APPROVAL: June 28, 2001

SHAILENDRA J. ANJARIA
Secretary