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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 01/12

10:00 a.m., February 5, 2001

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Decisions Taken Since Previous Board Meeting

Executive Board Attendance

H. Köhler, Chairman
S. Fischer, Acting Chairman

Executive Directors	**Alternate Executive Directors**
	A.S. Alosaimi
A. Barro Chambrier	D. Ondo Mañe
	P. Charleton
	P.R. Fenton, Temporary
	D. Guinigundo
	K. Ongley, Temporary
	S. Bonomo, Temporary
	B. Siegenthaler, Temporary
B. Esdar	
R. Faini	H. Vittas
	G. De Blasio, Temporary
D.I. Djojosobroto	Low K.M.
	R.A. Jayatissa
	N. Jadhav, Temporary
W. Kiekens	C. Josz, Temporary
	A. Fidjestøl, Temporary
K. Lissakers	J.M. Abbott, Temporary
	G. Bauche
	B. Couillault, Temporary
A. Mirakhor	M. Daïri
	I. Zakharchenkov, Temporary
	F. Varela
S. Pickford	
	R. Junguito
C.D.R. Rustomjee	I. Usman
A.S. Shaalan	K. Sakr, Temporary
Wei Benhua	Jin Qi
	E. Azoulay, Temporary
	P.A. Nijsse, Temporary
Y. Yoshimura	
	G.R. Le Fort
	R. Maino, Temporary

A.S. Linde, Acting Secretary
A. Mountford, Acting Secretary
R. Gudmundsson, Assistant
M. Schulte, Assistant,
O. Vongthieres, Assistant

Also Present

IBRD: C. Gray, Public Sector Group; K. McCollom, Europe and Central Asia Regional Office. African Department: J.T. Reitmaier, A.M. Scott. Asia and Pacific Department: S.A. Cook. European I Department: M.C. Deppler, Director; S.M. Schadler, Deputy Director; B.J. Aitken, C. Cottarelli, R. Moalla-Fetini, C.E. Pinerua. External Relations Department: C.N. Lotze, W.J. Murray. Fiscal Affairs Department: T.M. Ter-Minassian, Director; P.S. Heller, Deputy Director; G.T. Abed, M.A. Albino, K.-Y. Chu, B.J. Clements, J. Fournel, M.-T. Guin-Siu, S. Gupta, E.A. Mottu, B.H. Potter. Legal Department: B. Steinki. Monetary and Exchange Affairs Department: S. Ingves, Director; A. Cebotari, M.A. Josefsson, S.A. Seelig. Policy Development and Review Department: J.T. Boorman, Director; B.W. Ames, H.W. Bredenkamp, L.P. Ebrill, M.J. Fetherston, M. Fisher, A. Gilmour, U.J.M. Jacoby, C.H. Lim, D.G. McGettigan, J. Seade, H. Tadesse. Research Department: M. Mussa, Economic Counsellor and Director; A.O. Ilyina, P.R. Masson, A. Prati. Secretary's Department: S. Bhatia, L. Hubloue, T. Turner-Huggins. Treasurer's Department: B. Kaminska. Western Hemisphere Department: A.M. Jul, E. Weismann. Office of the Managing Director: S. Brown, Advisor; C. Salmon, Personal Assistant; D.A. Citrin; Office of Budget and Planning: E.-A. Conrad, Director; H.L. Mendis, T. Wolde-Semait. Advisors to Executive Directors: M.A. Ahmed, M.P. Bhatta, S. Çakır, V. de los Santos, S.S. Farid, N. Guetat, O. Himani, J. Jonáš, J.M. Jones, Liu F., M.F. Melhem, J. Ntamatungiro, C.-P. Schollmeier, J.R. Suárez, R. von Kleist, P.H. Whitehall, M. Yanase. Assistants to Executive Directors: S. Alcaide, V. Bhaskar, J.G. Borpujari, P.A. Brukoff, V. Dhanpaul, T. Elkjaer, I.C. Ioannou, B. Kelmanson, S.N. Kioa, T.-M. Kudiwu, J.K. Kwakye, P. Lathouly, J. Mafararikwa, W.C. Mañalac, E. Nyambal, L. Redifer, C.A.E. Sdralevich, A. Sutt, Tong Y., S. Vtyurina, M. Walsh.

1. EXECUTIVE DIRECTOR

The Executive Directors welcomed Mr. Guinigundo as Alternate Executive Director for Australia, Kiribati, Korea, Marshall Islands, Federated States of Micronesia, Mongolia, New Zealand, Palau, Papua New Guinea, Philippines, Samoa, Seychelles, Solomon Islands, Vanuatu.

2. TRACKING OF POVERTY-REDUCING PUBLIC SPENDING IN HEAVILY INDEBTED POOR COUNTRIES

The Executive Directors considered a staff paper, prepared jointly by the staffs of the Fund and the World Bank, on tracking poverty-reducing public spending in heavily indebted poor countries (SM/01/16, 1/19/01).

Mr. Daïri submitted the following statement:

> Although the immediate objective of the HIPC initiative is to relieve the debt burden of heavily-indebted poor countries (HIPCs), the ultimate goal is to use it as a vehicle to reduce poverty in recipient countries. That is why access to HIPC relief is made contingent on a prepared plan by a country for poverty reduction in addition to its progress under adjustment and reform programs. Therefore, a great deal of service will be done to the initiative if it is ensured that the assistance given is judiciously applied to relieving poverty. Herein lies the need to track poverty-related spending in HIPCs and monitor the impact of public spending, and we thank the staff of the Fund and the Bank for coming up with a well-researched and comprehensive paper on the subject.
>
> We agree with the staff that the task of tracking government spending on poverty is the country’s responsibility with the support of multilateral and bilateral creditors. This is indeed key to genuine ownership of country’s strategy. The exercise of tracking poverty-related spending in HIPCs should start with delineating the quantum of relief offered to a country. This may be complicated by the fact that HIPC assistance is not always delivered in the form of additional resources, but often in form of debt-stock reduction and rescheduling. To facilitate the exercise of measuring HIPC assistance, it is helpful, as the staffs suggest, to have the level of debt relief clearly indicated in the relevant IFI documents. It should also be included in recipient-country’s budget statements with an appropriate system in place to permit full transfer in the form of grants of relevant funds to the budget, including those going through the central bank or benefiting public enterprises. However, in cases where arrears on debt service are built up, it will be difficult to secure such transfers and it may be more appropriate to track total net external flows, as suggested by the staff.

A well-developed PEM system is required for effective tracking of poverty-related spending. But, as the study clearly reveals, a large majority of HIPCs have serious weaknesses with their PEM systems, which require substantial upgrading to bring them to acceptable standards. To this end, the greatest need, as the staff point out, lies at the budget execution and reporting levels.

A medium-term expenditure framework (MTEF) is the appropriate framework against which poverty-related spending may be tracked. Incorporating devolved levels of government and functionally- and program-classified expenditures, the MTEF can serve as a reference point for pre- and post-HIPC assistance assessment of changes in government spending. The MTEF, however, remains only a long-term goal of many HIPCs. Before a fully-developed and functional MTEF could be set up, an interim arrangement may be established for assessing likely patterns of spending, as the staff recommend, in the form of multi-year fiscal scenarios or through simple "before-after" comparisons. As the staff also suggest, budget line items may be tagged to constitute a "virtual fund" to be monitored under the overall budget execution process. The in-budget virtual fund approach would be preferable to creating a separate institutional poverty fund, which has the potential of undermining already established budget systems in HIPCs and which could lead to duplicative efforts and straining of limited administrative capacities.

To facilitate the tracking of poverty-related spending, PEM systems in HIPCs need to be improved. This could be best achieved through a collaborative effort between country counterparts, IFIs, and donors. It is reassuring that such an effort is already underway between the EU, the IMF, and World Bank. We favor a more active role of the Fund and the Bank in sensitizing and encouraging HIPCs to determine the need for improving their PEM systems and seeking the necessary assistance for capacity building and institutional reforms. Any agreed time-table for PEM system reforms could be incorporated into PRSPs to ensure effective implementation and monitoring. Capacity building in PEM system reforms needs to be properly sequenced within a suitable timeframe, making short-term needs consistent with and tailored to medium- and long-term needs. Given the strong need for capacity-building in PEM systems and the limited budgets of the Bank and the Fund, we agree with the staffs that additional support should be sought from other multilateral organizations and donors. We also favor continued collaboration between the staff of the Fund and the Bank working on HIPCs and basing resource allocation for PEM system reforms on identified need and potential benefits to a country. We encourage the two institutions to make the more efficient use of their limited resources and to avoid duplication of work.

In a real sense, it is neither practicable nor useful to track the poverty-reducing impact of HIPC relief in isolation. HIPC assistance is, invariably, linked to and coordinated with other poverty-alleviation programs, including those supported by the Fund and the Bank. We agree that it is preferable to adopt an all-inclusive monitoring of budgetary spending targeted to the poor. Periodic surveys of public spending flows are warranted, to be followed by benefit-incidence analyses from household and service delivery surveys. In carrying out benefit-incidence analyses, the yardstick should be that for public spending to contribute to poverty reduction, it must help the poor increase their incomes and access to basic resources. However, the specificity of policies and targets in poverty-reduction programs may vary from country to country, depending on particular circumstances and needs.

Tracking poverty-related public spending touches the very core of governance as it demands accountability and transparency in decision-making and implementation. It is also the best guarantee for effective delivery of HIPC assistance and other poverty-reduction programs. But, to be successful in enhancing ownership and achieving poverty-reduction objectives, care should be taken to adjust monitoring requirements to existing institutional and administrative capacities and to a realistic expectation for their strengthening. In this respect, we wonder whether the criteria used to assess the quality of PEM systems, for example: availability of monthly expenditure reports within four weeks, are realistic. We do not see any compelling need to monitor developments with such harsh time constraints that may overburden limited administrative capacity and detract from effective policy formulation. It is also important to limit quantified targets to those that can be directly linked to the authorities' policies and expenditure patterns.

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

This is a useful paper which addresses the various technical issues and capacity building requirements that are needed to track poverty-reducing public spending in HIPCs. This task is essential to assure creditors that the HIPC initiative resources are spent as intended and, more importantly, to help HIPCs manage and monitor their poverty reduction efforts. The paper proposes a strategy for the substantial work needed to achieve this task. In designing this strategy, the staff attempt to strike a balance between the demanding short- and medium- term goals, and the weak data situation and limited capacity in the vast majority of HIPCs. We find the proposed strategy to be generally appropriate and have the following remarks on its different aspects.

The staff recommend that tracking poverty-reducing spending be conducted through monitoring the overall composition of government spending, rather than institutional poverty funds. We find this approach appropriate, given the need to continue efforts to develop comprehensive budgets, and the fact that institutional poverty funds would not provide a complete perspective of poverty-reducing spending. This approach will also help focus the limited technical capacity and expertise in HIPCs. The paper argues that, in conducting this exercise, it would be extremely difficult to use a "with-without" approach as this would require building counter-factual scenarios in which hypothetical assumptions have to be made about the evolution of social expenditure in the absence of HIPC assistance. We therefore, find the much simpler but more feasible "before-after" approach to be appropriate.

The paper suggests that, over time, efforts could be directed to tracking poverty-related spending at the subnational level and to determining the extent to which this spending is becoming more pro-poor. This should, however, be a medium-term goal in view of the limited capacity and available resources. It is also well to note that this goal is more in the realm of World Bank mandate and expertise. Furthermore, a determination of the adequacy of the subnational distribution of expenditure can only be made by the authorities, and any advice or assessment in this regard should not come at the expense of national ownership.

Even with opting for an approach as simple and as straightforward as possible in tracking poverty-reducing spending, the staff have come to the conclusion that substantial efforts are needed to achieve the necessary capacity building. The staff rightly point out that this will require considerable resources and time, as well as significant technical assistance from the donor community, including the Bank and the Fund. We are concerned, however, that the paper is somewhat optimistic in assessing the resource requirements in the Bank and the Fund. For example, while the paper appropriately cautions that demand for technical assistance will only become clear once assessments are finalized, it states that 4-5 "person years" should be sufficient for the Fund to fulfill its substantial role in these efforts in CY 2001. We feel that this estimate is on the low side, and note that it also excludes the extra work needed from the staff in the area department who are already overburdened with the expanded work agenda in the Fund, including that related to PRGF programs and the lengthy and multiple HIPC documents. A streamlining of the documentation is called for to save resources, including at the country level, that could be directed to capacity building. The likely large magnitude of these resources highlights the need for substantial focusing and streamlining in our work and processes, and for more realistic estimates of extra resource needed to implement additional work. It is important to ensure that this additional work in tracking poverty-related spending does not affect the core responsibility to provide technical assistance to improve the budgetary process and execution in general.

In order to help face our resource constraints, the paper recommends continued cooperation with the World Bank. This is of course both desirable and essential. However, it is important that this coordination be accompanied by a clear division of labor and be conducted in an efficient fashion that minimizes any possible duplication of work or over-burdening of our staff who are significantly fewer in number. The paper also proposes that evidence of good utilization of technical assistance be a determining factor in assigning this assistance. While this is an important consideration, it is essential not to lose sight of the poor implementation capacity in most HIPCs and the assertion by the staff that time and patience will be needed. It is therefore important to be flexible and understanding of individual country circumstances in applying this rule. We also endorse the approach to work closely with country authorities to finalize the assessment of their own public expenditure management systems.

Finally, it is well to note that without directing priority to capacity building in the area of effective and efficient implementation, not only in the area of tracking spending, the poverty reduction endeavor will be compromised.

Mr. Suarez submitted the following statement:

The document that the staff has prepared for this discussion is clear and comprehensive. Before turning to the specific issues for consideration, let me first note that tracking of poverty-reducing public spending in heavily-indebted poor countries is a necessary step to ensure an adequate use of debt relief provided by the international community, after countries achieve their decision point. Therefore, every effort made to establish a system that could help to asses if debt relief is channeled in a sound manner while contributing to the main purpose of the HIPC initiative, namely reducing poverty, is a welcome step.

The paper before us addresses some of the concerns that have been expressed in previous Board discussions: Public expenditure management, strengthening the capacity to track poverty-reducing spending--including principles of expenditure tracking—are a recommended approach.

Let me turn now to the issues suggested by the staff for discussion:

Undoubtedly, the need for HIPCs to benefit from the Initiative is associated to adequate and timely financial assistance that could be delivered by the international community, given the financial constraints that many countries face when implementing programs aimed at reducing poverty, but it is also associated to the good use that governments make not only of these resources but of its own budget resources. It is also clear that HIPC assistance itself will not cover all the demanding social needs of this group of countries. In that regard, we fully concur with the staff that trying to track only HIPC assistance for poverty reduction objectives will provide only a partial perspective. Government’s strategies to reduce poverty have been described on the PRSPs presented by each country to the Board during decision point considerations. Although in many cases the estimated cost of the different programs and actions contemplated in those strategies was not included, it is expected that these costs will be covered by government budgets including external financial assistance provided as debt relief. The average time envisaged by governments for achieving the goals of reducing poverty is about 15 years. Thus, the costing of the whole strategy must be envisaged in long-term horizon in an environment of macroeconomic stability. For that reason the overall composition of government spending to become more pro-poor is, in my view, an adequate approach.

The staff rightly highlights that a pragmatic approach built on existing systems is necessary in the short term. Given the limited capacity of many HIPCs one good starting point could be the use of a "before-after" comparison, as suggested by the staff, or the use of baseline multi-year projections made before the provision of HIPC assistance. This exercise can help in the process of measuring changes in spending patterns. However, in fairness to ourselves, we should persist in the need to strengthen the PEM in developing countries in order to have a medium-term expenditure framework (MTEF). Indeed, this would be a great contribution to HIPCs countries when assessing the impact of their public spending to benefit the poor.

The staff are soliciting views with regard to a more proactive role of the IMF and World Bank to encourage countries to undertake PEM assessments and to seek assistance for capacity building and related institutional and governance reforms. It is in the interest of the poor that the HIPC Initiative was implemented; therefore, the effective use of debt relief is expected to have a positive high impact on the poor. Furthermore, the preliminary findings of the staff on the exercise carried out for the 25 HIPCs on the quality of central government PEM systems conclude that there is a strong need to upgrade the PEM systems in most HIPCs. Therefore, I would like to support this approach. In this connection, technical assistance provided by both institutions can significantly contribute to the HIPCs' efforts in strengthening their capacity building.

Cooperation between the two institutions should continue for working in HIPCs. In this regard, it is important to take into consideration that we need to complement the expertise in the different fields of involvement of the Fund and the Bank in order to maximize the use of the limited resources. We also support the use of the four criteria items for PEM work when allocating these resources.

The main challenge at this stage is to further work with the country counterparts to finalize the joint IMF/World Bank assessments of PEM systems. We consider this an important part of the process, since most of the work done was made within desk economists of these institutions. In this regard, it would be desirable to intensify contact with relevant officials of

HIPCs governments to define priorities. It is likely that several consultations will be required; thus, we urge the staff to give the highest priority to these discussions, so that adequate progress can be achieved. The staff mentioned the need of incentive programs in different aspects of the process of tracking poverty-reducing expenditures and the use of HIPC assistance. I would appreciate it if the staff could elaborate on what kind of incentives could be put in place to ensure effective tracking.

Finally, on the last two issues for discussion we are fully convinced that any contribution is critical to meet the demands by HIPCs for capacity building. On the need to establish mechanisms that would also enable the tracking of poverty-related spending at the sub national level, we would expect--taking into account that many efforts for reducing poverty will be aimed at rural areas--that there would be a need to move in this direction within the medium term, with a view to focus on the effectiveness and social impact of such spending.

Mr. Djojosubroto submitted the following statement:

We agree with the staff that the task of tracking public spending on poverty is the responsibility of individual countries. It is in the interest of governments to monitor the usage of public funds to ensure the success of their poverty reducing strategies. At the same time, the onus is on individual countries that have received international assistance to adequately assure the international and donor communities that the resources have been utilized as intended. In this regard, we thank the staff for their ongoing efforts to assist HIPC countries ensure that the debt relieves provided to them are utilized in the most effective way to meet the intended objective of alleviating poverty.

For countries at the higher spectrum of development, having a good public expenditure management system should be part and parcel of their strategy to enhance transparency and accountability in public expenditure, and contributes towards good governance. While this should be the desire of every country, in the case of HIPCs, however, such a comprehensive public expenditure management system can only be a long-term objective given their resource and administrative constraints. Recognizing that there are outstanding and competing demands for HIPC assistance from other countries, every effort is needed to ensure that all public expenditures are properly managed and effectively utilized to the best of a country's ability. We therefore agree that it is important to track the overall composition of government spending in accordance with the spirit of the HIPC initiative. However, the presence of such a tracking mechanism should not be seen as a prior condition for the use of HIPC assistance.

As the HIPCs are in different stages of development, with different levels of institutional capacities, their ability to track and monitor the use of

HIPC resources would vary accordingly. To meet the requirements of the tracking system that the staff have in mind, most of the HIPCs would need some upgrading of their existing public expenditure management systems. While we agree that it is important to monitor the direction and level of HIPC spending right from the initial stages of the program, a management system that is tailor-made to suit the local set-up would be the best approach. While we can aim for a more comprehensive public expenditure management system to be established as a long-term objective, the use of a simpler and more readily usable approach (i.e., the "before-after approach") to track overall public expenditure, particularly the poverty reduction programs, would be the appropriate way forward.

Tailoring the technical assistance provided by the Fund and Bank in public expenditure management to appropriately match the different capacity levels of the HIPCs is very important, not only for the usefulness of the TA provided, but also for the long term effectiveness of the HIPC Initiative. We agree that the Fund and Bank should take a more proactive approach to encourage countries to undertake public expenditure management assessments, and seek assistance for capacity building. However, we believe that it is more appropriate for the Bank to take the lead in such efforts, as they are more within the mandate of the Bank than the Fund. We would also suggest that we can tap the technical expertise from developing countries, because their experiences would be more applicable given the level of technical expertise available in the HIPC country.

We agree that strengthening the public expenditure management systems of HIPCs will contribute to the success of the HIPC Initiative. However, with the limited resources available, it is important to have clear criteria and guidelines for allocation of the assistance and we are generally agreeable with those listed in paragraph 39. However, using the past track-record as one of the criteria would be problematic. First, it appears to be a redundant criterion because the appropriate track record of all HIPC recipients would have already been assessed before HIPC assistance is approved. Secondly, imposing these criteria could be unfair to some countries. For instance, for a country that had a recent change in government, the newly elected government could be unfairly penalized for the policies of the past administration. We suggest that the criteria should therefore be forward looking, assessing the present government's sincerity in ensuring that the assistance will be effectively used to reduce poverty.

Ms. Lissakers and Ms. Redifer submitted the following statement:

The paper highlights the difficulties countries will face in tracking poverty reduction expenditures, and of what IFIs' and countries' ultimate objectives in devising public expenditure management systems should be. What it does not offer is sufficiently detailed information on short-term bridging mechanisms that provide credible assurances that HIPC resources – and other donor funding – are being used effectively for poverty reduction and that support long-term efforts toward comprehensive budget transparency. Rather, it focuses on attacking off-budget, HIPC-specific accounts (which we agree are not sensible) giving an initial impression that this is the only alternative until more comprehensive budget improvements are fully realized. We do agree that near-term efforts should complement and provide a basis for creating strong, effective and comprehensive expenditure management systems over the longer term.

Strengthening public expenditure management systems in borrowing countries should be a core function of the institutions. We need to signal that clearly and outline efforts already underway to address the longer-term goals of strong public expenditure management systems in borrowing member countries (some of information in Section III B). In its current form, the paper sends quite a different message – that the Bank and Fund do not think the majority of HIPCs, and quite likely IDA/PRGF countries, can track public expenditures, and the IFIs cannot address this problem without more money. The suggestion that existing resources are insufficient for achieving even basic improvement in countries' public expenditure management systems puts into question whether the institutions are effectively carrying out a core function needed to support their current activities, particularly given the shift to programmatic lending on the Bank side.

Expenditure Tracking in the Short Term is Important for the Momentum of the Initiative

The paper describes at length how short-term expenditure tracking systems can undermine longer, more comprehensive reform efforts if not constructed properly. However, the integrity of the Enhanced HIPC Initiative rests on our ability to demonstrate with sufficient certainty how resources are being used for additional poverty spending. The Bank/Fund joint paper on PRSP Status and Next Steps states that "PRSPs will need to include clear, monitorable key actions that would allow a country to reach its completion point under the HIPC initiative. It is essential in this context that all available resources are integrated in a transparent, accountable budgetary framework, which could include poverty/social funds, to ensure their effective use to combat poverty."

The paper states that only a handful of countries will be able to trace poverty spending prior to their completion points, without defining any baseline for that. However, in the middle of the paper, starting on page 10, the staff does present some intermediate steps that can be taken to track poverty spending. Paragraphs 22 and 23 provide some guidance on bridge tracking mechanisms to address immediate needs while continuing to build overall public expenditure management systems over the longer term. Similarly, in paragraphs 33 and 34, the staff states that authorities should establish short and medium priorities for improving public expenditure management. These priorities will be incorporated into negotiated program conditionality, as well as help meet expectations for HIPC completion points. Indeed, for most countries, progress in improving public expenditure management and illustrating the use of HIPC resources is, in some form or another, an explicit requirement for reaching the HIPC completion point. These sections of the paper need to be expanded and brought forward.

As far as a simple before-after definition of a baseline is concerned, footnote 15 implies that countries that have already received HIPC I assistance should not be required to include increased poverty spending after HIPC I (but pre-HIPC II) in their baseline for assessing additional spending under HIPC II. Can the staff clarify and explain the basis for this view? The discussion on suitable interim tracking mechanisms to address immediate needs would be greatly facilitated by more country-by-country information on existing bridging mechanisms in use (e.g., virtual poverty funds) as well as how current systems measure up against the longer-term basic public expenditure benchmarks outlined in the paper.

Use of a "Poverty Fund" as a Bridging Mechanism

In previous HIPC discussions, Executive Directors and NGOs have asked whether "poverty funds" to monitor poverty reduction spending could serve as a bridging mechanism to a more comprehensive overhaul of public expenditure management. Section II of the paper explains why an off-budget poverty fund, with special hiring authority, etc., could divert scarce resources from improvement of overall public expenditure management and not necessarily do a good job of identifying increases in poverty spending. As far as we are aware, Directors have not pressed for off-budget funds, nor have they spoken in favor of special hiring practices. They have argued that a poverty fund could be subject to special monitoring and reporting requirements, which is a separable concept.

Measuring HIPC Assistance

For most countries the increase in poverty spending should equal or exceed the value of the fiscal impact of HIPC assistance, i.e. resources "freed" by HIPC assistance, per current section III A of the paper. We were pleased to see inclusion of this section, and a few comments follow. First, in paragraph 11, government should be more than "encouraged" to include data on the fiscal impact of HIPC assistance in their budgets. Second, in paragraph 12, if Fund delivery of HIPC assistance is included in central bank profit transfers to the budget, even with a lag, it should be relatively easy to identify as a subset of the overall profit. Third, in paragraph 14, the wording "…HIPC assistance may in fact result in increased debt service payments" needs to be clarified by pulling the concept of regularizing relations with creditors up from the next sentence and removing the potentially misleading causal wording.

Conclusion

We believe this paper should be reworked to present a clearer set of options for short-term monitoring structures for poverty related, expenditures, including from the fiscal resources related to HIPC, that can be expanded over time. Also, a judgment by the Bank and Fund staff is needed on whether existing processes can be strengthened in the near term to provide a credible test for the purposes of reaching HIPC completion points, as well as other IFI lending. The staff needs to present the Boards with proposals on "what is possible now" within existing capacity and resource constraints. We view this paper as a working draft since it does not provide that information.

The Acting Chairman said that the statement by Ms. Lissakers and Ms. Redifer raised an important issue about the tone of the staff paper. He therefore asked Ms. Lissakers to summarize it briefly before asking the staff to comment on the important issues raised in the statements.

Ms. Lissakers remarked that the review paper was an important and valuable exercise. It pointed to the core areas that needed the full engagement of the Bank and the Fund, and clearly demanded considerable technical assistance, because the message was that most of the beneficiaries of HIPC did not have effective, fully satisfactory, or even rudimentary public expenditure management systems to begin with. While it was debatable how one defined public spending and by what standards, the message that the staff paper seemed to be sending was both wrong and potentially damaging to the HIPC Initiative, as it was integral to the HIPC Initiative that debt relief be devoted to increased poverty spending and poverty-reduction efforts in the beneficiary countries. The first two-thirds of the staff report led the readers to conclude that currently there was no possibility of making that determination in most of the HIPC beneficiaries, that there was not sufficient tracking ability, and that there were no intermediate steps to take to track poverty spending so as to meet the standard that was embedded in the HIPC Initiative itself. In fact, there was already a tracking mechanism even in the 16 HIPCs that were mentioned, and there clearly were intermediate steps and intermediate benchmarks one could set in order to meet the HIPC core requirement. The report thus needed to be revised to make clear what the intermediate steps were before proceeding to consider a high standard public management system. Such a revision along that line would encourage HIPCs to move forward and lend support to the credibility of the HIPC Initiative.

The staff representative from the Fiscal Affairs Department, responding to questions from Executive Directors, explained that the staff paper prepared for the Board described how to track shifts in pro-poor expenditure composition on the basis of available functional data and, by tagging and monitoring selected poverty reduction programs in a "virtual" poverty fund. The paper proposed an approach that entailed comparing expenditure composition before and after the receipt of HIPC assistance. That comparison would allow the authorities to monitor, and the staff to report, proposed changes in the composition of public spending. However, while functional data gave an indication of shifts toward general social programs—such as for education and health—they did not identify the pro-poor component within such broad categories. Not all education and health spending could be taken as poverty reducing, for example. In comparison, virtual poverty funds, as proposed in the paper, could offer a way of tracking specific programs behind those broad shifts, and, if used in conjunction with a broader set of data, could also help identify additional programs resulting from the HIPC Initiative. Those programs were typically defined in PRSPs, and two-thirds of HIPCs appeared to have the capacity to set up a virtual fund corresponding to the poverty-reducing spending identified in PRSPs. However, in preparing full-fledged PRSPs, some assistance might be required to help countries align the virtual poverty fund with those poverty-reducing programs. Using a program classification could further enhance the tracking of poverty-reducing spending in the budget. That would capture all poverty-reducing spending programs, both within and outside a virtual poverty fund, and provide the basis for subsequent analyses of the impact on the poor of the shift to a more pro-poor composition of public spending. However, weaknesses in PEM systems for most HIPCs were likely to affect the adequacy and timeliness of reporting outturns of both broad shifts and programs in the virtual fund. The preliminary assessments found that the capacity to track outturns varied considerably across countries—over 60 percent of HIPCs had weaknesses in the timeliness and reliability of reporting disaggregated data.

The second staff representative from the Fiscal Affairs Department said that the main issue was the quality of available data. The Board was aware of many problems regarding outturn data—payment arrears, the overuse of suspense accounts, the differences between budgeted total spending and its allocation and outturn, and the difficulties in reconciling fiscal and monetary data. Therefore, the main message one would try to deliver was that it was not a question of the ability to track spending as data were available at the budget preparation stage as well as at the final execution stage. Rather, the issue was about the quality, reliability, timeliness, accuracy, and comprehensiveness of the data available. Recent experience with many of the countries suggested that with the country's commitment and external assistance, real improvement could be achieved. In several countries, progress had been made on commitment control systems, external audit, and routine reconciliation of monetary and fiscal data. The task was to spread those practices that were being observed in the best performers among HIPCs to other countries as well, through a combination of Fund resident experts and missions, Bank assistance in developing better PEM systems, and support from bilateral donors to further improve the quality of data.

The basic question remained as to whether the Board could be assured that the capacity would be sufficiently enhanced relative to the present status, the staff representative continued. The staff was of the view that, in advance of undertaking the full assessments—which would be the next stage—it would be unwise to offer any overall judgment. Data at the broadest level existed for almost all HIPCs, and good information at a disaggregated level was available for many countries. In two cases, relatively little upgrading was required; in several others, some investment would be required that could be secured in 1-2 years. For the rest, a more sustained effort would be needed to make substantial progress, provided there was sufficient political will to make the improvements. As was proposed in the staff report, a two-step approach was envisaged whereby the Bank and Fund staffs would, first, finalize a preliminary assessment for the country authorities, and, second, based on those assessments, draw up action plans to address those weaknesses over the short to medium term. Incremental benchmarks, as suggested by Directors, would be useful as progress would be incremental—for example, in reducing the delay in producing data, deepening the functional data classification, and improving the reconciliation system. However, priorities and needs would vary from country to country. The staff would report to the Board later in 2001 on the real magnitude of the task, and the identification of intermediate benchmarks on a country-by-country basis.

On the question of standard setting, the staff was conscious of the need to have sufficiently high standards to give assurances to the Board, while at the same time allowing for some flexibility, the staff representative said. While Directors might have noted that one of the indicators was perhaps too narrow, they could be assured that flexibility would be employed by the staff. But any substantial weakening of the standards would be unwise. Two of the HIPCs were currently very close to meeting those standards, and another group of countries was not too far behind. Those standards were needed to enhance the understanding of what had evolved in terms of the use of HIPC resources and a broader attack on poverty.

Regarding the relative roles of the Bank and the Fund in this process, the staff representative noted that, while public sector work was carried out in both institutions, in moving forward, the two organizations would strengthen the complementarity of their work by building on the good collaboration achieved in preparing the preliminary assessments. There was a clear delineation in terms of expertise and responsibilities. Fund involvement in HIPCs would focus on ensuring a proper classification of expenditure programs and on short-term improvements to provide timely and accurate accounting and reporting of spending under those programs. This work would go hand in hand with the focus of the Bank, which would remain on medium-term structural and institutional issues related to poverty reduction. As those programs came to fruition, and as the Bank took on the main responsibility for assessing outcomes related to poverty and social indicators, the Fund's assistance would be scaled back. In other words, Fund assistance was at the upfront stage on the classification and short-term improvements in the outturn data.

The above process would have certain implications for Fiscal Affairs Department resources, but the true extent of the demand for Fiscal Affairs Department technical assistance could only become clear once the assessments were finalized, action plans prepared, and the contribution of other donors to that effort was known, the staff representative continued. That process was expected to be completed before the end of 2001. In the meantime, Fiscal Affairs Department was prepared to allocate 4-5 staff years in 2001 to assist country authorities in finalizing PEM assessments and drawing up action plans. This would require some offsetting reductions elsewhere, for example, by delaying traditional technical assistance. This estimate was prepared on the basis of certain assumptions about the number of existing Fiscal Affairs Department missions in relevant areas and the number of resident experts in place.

On the appropriateness of the use of track record in allocating resources to HIPCs, the staff representative from the Fiscal Affairs Department explained that the track record was only one way to assess the absorptive capacity and commitment of the country to upgrade PEM systems. The record of past use of donor assistance could help identify the factors conditioning demand for, and capacity to absorb such assistance. Though backward-looking, such an assessment gave an indication of measures needed to promote an effective use of technical assistance. However, as the staff report noted, that was only one of the many criteria, and should be used flexibly.

On another point, the staff representative explained that the staff did not suggest an adjustment for the HIPC Initiative in the baseline, for the "before and after" approach, but cautioned against using the enhanced HIPC year as the baseline for the countries that had previously received HIPC assistance. For those countries, a tilt in favor of poverty-reducing programs would have already begun. For example, in Uganda, the staff report rightly used a base year pre-dating the original HIPC Initiative.

Mr. Daïri said that he supported the point made by Mr. Djojosubroto about the need to be forward-looking, and to avoid relying exclusively on the track record of HIPCs. There were countries that experienced a change of government, or even if there was no change in government, there might be a change in the degree of commitment to reform. Those changes had to be taken into consideration. He also agreed with Ms. Lissakers that the Fund should take into account the possibility of upgrading capacities in member countries within a very short period of time. In particular, it needed to be more careful and evenhanded, in the use of standards for the whole membership. It was easier, for example, for emerging markets trying to enter the international capital markets to seek to meet the established standards than it was for poor developing countries where the administrative capabilities could be extremely diverse. Instead of seeking high standards in terms of implementation or tracking, one had to be realistic. For this reason, he did not favor the use of a track record in implementing past assistance with detailed expenditure specified. Some of the advanced economies themselves, and many developing countries, could not provide such information. While HIPCs needed international assistance, thus being subject to higher scrutiny, it was unfair to impose higher constraints on them, simply because they were seeking international assistance.

Ms. Lissakers asserted that she did not argue for lowering standards, but was concerned about the suggestion that there was no possible path between the present stage and the achievement of higher standards. The way the Fund had defined standards in the standards and codes exercise gave countries a goal to strive for, and presumably some path to reach it, as well as a benchmark to measure their performance against. Thus, the path should also be defined clearly in the PEM exercise, with the intermediate steps or benchmarks to meet the standards. There were two measuring exercises that were important to the HIPC Initiative. One was to measure outturns, which took time to assess if the objective was achieved with HIPC resources and better poverty spending. The other was to measure effort in some meaningful way. Both aspects were not clearly laid out in the staff report. Therefore, the staff needed to revise it somewhat. Also, it had to be understood that countries should not reject standards for the reason that they were far from meeting them. To make the work of the Fund and the Bank more effective, the objectives had to be clearly defined.

Mr. Daïri argued that it was important to maintain standards if they were used basically to indicate what needed to be done by the international community—including the Fund, Bank, and donors—to help the countries meet those standards in the long term. However, those standards would not be useful if they were used simply to show which countries failed, or did not make an effort, to meet the standards. The Fund should avoid giving the impression that the countries that did not achieve the standards had bad governance or poor capacity, and were responsible for such a poor performance. Rather, the Fund should be forward-looking and ensure that the standards were more helpful to the membership.

Mr. Pickford, agreeing with Mr. Daïri's second intervention, said that there was a risk of sidetracking on the issue of standards, and that it would be damaging to HIPCs if the level of standards was weakened, as two countries were close to achieving the standards already. There was an absolute need for a rapid assessment of each country's situation and to draw up both short- and medium-term action plans quickly. While the short term action plan would provide basic assurances, it would have to be supplemented by a medium-term program for bringing the country's whole budget and financial management systems up to the point where the country itself could have the assurance that its efforts were on the right track and in the interest of the country. The staff's intention to issue the first round of assessment by the end of 2001 raised some concern; higher priority should be put on the assessment of the current situation, which would provide the basis for the drafting of an action plan. In consultation with the country authorities, that process could be pursued more rapidly, with the time frame being indicated clearly. Subsequently, the staff could start to identify the absolute immediate priorities and the longer-term aspirations, and to ensure that the immediate actions were consistent with the medium-term trajectory and plan, while, at the same time, bringing in all the various players—the multilateral organizations, such as the World Bank and the regional development banks, and the donors, most of which were heavily involved in providing technical assistance in this area, and thus could play an important role. Such efforts needed to be coordinated, consistent with the overall approach.

Mr. Barro Chambrier added that it would be important to put in place intermediate targets to reach the standards, as suggested by Ms. Lissakers, and agreed with Mr. Daïri that the Fund should not underestimate the weaknesses of administrative capacity in HIPCs. Since the beginning of the HIPC Initiative, considerable progress had been made, but more was required. In that regard, one issue missing in the debate was the resource requirement for achieving the short-term goals. Prompt, well-targeted technical assistance would require considerable effort from the donor community.

The Acting Chairman clarified that the use of the word "standards" in this exercise differed from the other standards used in the context of ROSCs. Here, it was used to indicate a level that could be reached. On the tone of the staff paper, the staff had been very careful, particularly in the beginning of the paper. On the positive side, the functional classifications of spending could be tracked—though with some delay—and the virtual budget enhanced the ability to see how the HIPC funds were used. Both elements provided further indication of whether, in large categories, there had been an offset in terms of other spending that had been moved elsewhere, relative to the money that was being spent in HIPCs on those targeted areas, as each of the items in the virtual budget illustrated how it would fit into the functional classification. Nevertheless, money was fungible, and thus could be taken out of somewhere and put somewhere else, for example, from poverty-reducing expenditures within a functional category to those not regarded as poverty-reducing expenditures. All that mattered was that the principles were well understood, and the results were rightly anticipated. The difficulty in those budgets was that there was not strong budget control or sufficient ability within the system to do all those elaborate maneuvers. HIPCs were not trying deliberately to subvert the functioning of their system, but simply lacked a tracking system. Therefore, a massive problem was not expected on a systematic basis, given that countries understood the goals of the HIPC Initiative and the participatory process by which the PRSPs were drawn up, as well as the fact that more emphasis was put on tracking by the recipients. The staff could write the first part of the paper in a more positive tone to reflect that more could be done, and describe the action plan for improving the situation toward reaching the standards by putting in place the capacity to make the initiative work more effectively. Judging from the sense of the Board, that would be a satisfactory approach, and would be consistent with the staff's informing the Board that this system was far from perfect, and that there could be divergences between expectations and reality.

The second staff representative from the Fiscal Affairs Department agreed that the word "standards" should be replaced by "benchmarks." The staff had tried to establish benchmarks across 15 indicators, using 36 questions to assess the conditions in HIPCs. In certain cases, the staff had also asked about the capacity to report monthly expenditure quickly based upon the availability of above-the-line data coming from the line ministries, rather than asking whether the authorities could report total monthly expenditures within four weeks. Four HIPCs could report monthly expenditures within four weeks, and another 12 countries were able to do so roughly within four weeks. On a related point, it was important to distinguish between benchmarks and intermediate steps. The staff had not been able to set up benchmarks in advance to reflect the general capabilities and limitations of PEM systems in the 25 HIPCs, nor had it had enough knowledge to establish intermediate points that would have been applicable across those countries. For example, one could envisage different intermediate points for the Francophone and the Anglophone countries. Such intermediate steps would have to be defined after the completion of country-by-country assessments. That was also true for the action plans, in which a reasonable time frame needed to be identified for individual countries. At the time of the drafting of the staff report, it would not have been sensible to conjecture what those stopping points might be.

Mr. Daïri supported the Acting Chairman's proposal to present the staff report in a more positive way, and noted that improvements in the administrative capacities and tracking and monitoring were desirable not only in the context of the HIPC Initiative. The Fund should consider strengthening administrative capacity and policy formulation and monitoring on its own merit as a long-term objective for all countries.

Mr. Barro Chambrier made the following statement:

> I would like to thank the staff for this concise paper, and I believe this is a critical discussion in a long-term perspective.

The results presented in the report are not surprising, at least for countries in my constituency, because weaknesses in budgetary procedures, and in expenditure management, have been documented in previous staff reports, and somewhat addressed in the context of Fund-supported programs and technical assistance. The current paper is a good preliminary document, and I look forward to the planned refinement of these findings through consultation with country authorities. The paper highlights the link between expenditure tracking and other issues of relevance to HIPC countries, like transparency, good governance, and the need for targeting technical assistance and efficient coordination.

Let me limit my comments to six main points.

Strengthening budgetary procedures and improving expenditure management has been a source of concern for quite some time and reform measures have been undertaken in the context of Fund-Bank supported programs. However, progress to date has been modest in most cases, and as stressed by Mr. Daïri, a large majority of HIPCs have serious weaknesses with their public expenditure management systems, and there are still enormous and justified needs for technical assistance.

Here, I share the same frustration as Ms. Lissakers on the preliminary finding that existing Bank-Fund resources are insufficient for establishing rapidly basic expenditure management systems in HIPCs. It is even more pressing to cover these needs now in order to efficiently track budgetary appropriation and the execution of proper spending, and to ensure that budgetary resources reach the intended beneficiaries. This will also contribute to the strengthening of transparency and good governance in public finance. In addition, the involvement of civil society and donors in the context of the PRSP process, together with administrative decentralization, should increase accountability and help ensure that HIPC resources are effectively directed to poverty alleviation.

Second, it is encouraging to see that HIPC countries are aware of the need to track poverty-reducing spending. As the Fund, the Bank, and the rest of the international financial community seek to help them in these efforts, I would caution against the use of quick fixes and shortcuts, as pointed out by Mr. Shaalan and Mr. Sakr. Time and patience will be needed in the strengthening of public expenditure management. In that sense, I concur with the staff that the use of separate institutional poverty funds should be avoided. As explained in the report, such funds, unlike virtual funds, will create parallel budget execution channels that will undermine the existing institutional mechanisms, without ensuring the achievement of expected results for poverty-reducing spending.

Also, as pointed out by the staff, capacity building should go hand in hand with institution building. At the same time, however, I agree with Ms. Lissakers and Ms. Redifer that short-term bridging mechanisms are necessary to provide assurance of the effective use of HIPC resources. However, short-term remedies to weaknesses in public expenditure management should be adopted in the context of a comprehensive medium-term framework, which also takes into account the tracking of poverty-related spending at the sub-national level. This is consistent with the gradual and realistic approach that this chair has always advocated regarding the data to be provided by poor countries, in view of their limited administrative capacities and the lack of efficient institutional mechanisms.

Third, on the allocation of technical assistance (TA) resources, like Mr. Djojosubroto, I would like to caution against a mechanistic use of the track record, as indicated in paragraph 39 of the staff report. While I generally agree with the principle and call for an efficient use of scarce TA resources, the provision of TA for the reinforcement of budgetary procedures and public expenditure management should be a forward-looking process. Denying the needed TA to a country receiving assistance under the HIPC Initiative on the ground of past inefficiencies in the use of TA will create double standards in the group and will be hard to justify. I would rather call for a new approach with closer monitoring and follow-up. And here, I see a role for resident representatives to help country authorities avoid past pitfalls. In addition, country ownership should be strengthened by closely involving the authorities in the identification, implementation, monitoring, and evaluation of TA. Given the limited resources, I encourage the establishment of clear action plans for the use of technical assistance.

Fourth, on the approach, I fully endorse the general approach whereby the overall composition of government spending and the extent to which it becomes proper over time is tracked. This will also help countries link budget allocation and execution with the priorities set in their poverty reduction strategies. However, we should always have in mind that the availability of HIPC resources is conditional on the mobilization of domestic revenue. Therefore, the strengthening of public expenditure management should go hand in hand with the improvement of revenue mobilization.

Fifth, on the dialogue between country authorities and the Fund and the Bank, I would like to encourage a constructive and continued dialogue. Prompting countries proactively to undertake public expenditure management assessment and to seek TA is important. However, learning from past experience, I reiterate my call for a strengthened monitoring and follow-up. In the same vein, continued cooperation between the Fund and Bank staffs working on HIPCs will be instrumental in building capacity and institutions. But, as I said earlier, this applies also to resident representatives of the Fund and the Bank in the field.

Sixth, on contributions from other donors, given the magnitude of the need for TA in capacity and institution building in the area of expenditure management, and also given the financial constraints of the Fund and the Bank, contributions from other multilateral institutions and bilateral donors will facilitate the achievement of these objectives. However, it should be noted that coordination of these efforts plays an important role for an efficient use of TA resources. Also, while country authorities have the primary role for coordination, TA providers could also put in place mechanisms aimed at avoiding duplication and waste of resources. As underlined in our recent discussion on the coordination of TA, this entails administrative costs that need to be covered.

Mr. Rustomjee made the following statement:

Introduction

I thank the staff for this important and insightful paper. We cannot agree more on the need to strengthen public expenditure management (PEM) systems as well as to enhance the capacity to track expenditures in HIPCs. At the outset, I would like to associate myself with the points made by Mr. Barro Chambrier; would like to ask one question; and must admit to some confusion. The question is: how are we distinguishing between expenditure tracking and expenditure management? Even if we step aside from the discussion whether the expenditures to be tracked or managed are all budget expenditures; or all poverty-reducing expenditures; or all HIPC-related expenditures only–what distinguishes "tracking" from "management"? Do the staff see these as the same; or is tracking a sub-set of "management." I raise this issue, because I have struggled, in reading this detailed paper, to place the discussion in the context of our existing Fund policies. Is our focus on tracking something new; or, at the other extreme, do we already have provisions to address this issue—are we duplicating, or are we truly focusing on a new issue?

We have a small, concise paper today, but it touches on many very major issues. The paper, if it is accurate, can lead us to a number of quite profound conclusions. Conclusions about what we, the Bretton Woods Institutions, have been doing in the area of expenditure management over a number of years; about how much or how little our advice has been heeded; about the depth and complexity of the problem of expenditure management in low-income countries; about the fragility of efforts to address better public management; and about the quantum of resources that are necessary, as well as the length of time they need to be made available for, to adequately address expenditure management. Directly for the purposes of Fund policy, today's discussion on tracking is crucial because of its linkages with many other ongoing and evolving areas of Fund policy. And I would like to take a moment to briefly reflect on these, largely to make the point that our discussion today has a context, and that the outcome of our discussion will have wide ramifications for many other areas of policy.

The discussion on tracking seems to touch on at least five areas on which we already have related Fund policies. First, there is the link to the PRSP process, which at least in my mind, is one of the foundations from which this new discussion of tracking springs. But if we are all agreed on that, this new discussion raise some troubling aspects. In the new document on tracking, by way of an example, we begin to recognize that poverty-stricken members ought to focus on improving PEM systems, in the first instance at the national government level: and that only later are they likely to develop effective capacity to address expenditure management at more decentralized levels. Yet, in the last 17 months, the PRSP processes of many countries have explicitly taken on board the objective of adopting, much earlier, a decentralized approach to budgeting. The PRSP process seems to be getting ahead of what the current paper is signaling as a capacity reality. How should we be reconciling this?

Then, aside from the link to the PRSP, the paper also has links to HIPC conditionality. If by tracking we really mean "management," then we are effectively discussing, in the current paper, our policy on Fund conditionality, as it applies to the management of the fiscal deficit in low-income countries; and subsequently to how the deficit is to be financed. If, on the other hand, by tracking we are referring to a simpler activity of ex-post monitoring of expenditure patterns, then the framework of our discussion is much more limited. But I suspect the we are talking of more than this in today's discussion. So we do need to be clear what we really mean when we are referring to "tracking."

And, of course, there is a more direct link to our evolving policy on HIPC conditionality. Regardless of whether "tracking" means management, conditionality to better track or manage expenditures already seems to be present. All floating completion points documents refer in one way or another to the need to develop better budget management systems. Some go so far as to insist on developing MTEFs, which our Chair has argued to be a long-term objective, requiring very substantial resources and which it is unrealistic to include in floating completion point conditionality. Yet today's paper tells us that the money is not there to do the job; and the combination of our current conditionality and the current paper tells us, or seems to tell us, that we have now insisted on conditionality that the members say will take much longer than expected to develop, and which we are saying we cannot help them develop because we do not have the money. Have we set up unsustainable conditionality, which is of course, neither in the Fund's nor our members' interests?

And this leads to another linkage, which is stimulated by the paper; and that is the linkage with our policy on misreporting. The paper notes the varying degrees of difficulty experienced by members in developing sound expenditure tracking, or expenditure management systems. This, of course, means that current data and information are, at least for 23 of the 25 HIPCs and probably many more low-income countries, of questionable accuracy. This makes the case for proceeding cautiously in our treatment of data from HIPC countries, in the context of misreporting and puts an important, but real barrier in the way of any quick and clear cut judgment as to whether or not a HIPC or low-income country has "misreported."

My final opening observation is that the paper raises important issues pertaining to another area of evolving policy in the Fund, and that is our policy approach to ownership and conditionality. By recognizing that there is no money for countries to develop their PEM systems and to address poverty reduction objectives, is it the implication of the findings of this paper that members should make the choice, between spending scarce resources on PEM systems and spending money on poverty reduction? If there is a trade-off, how should countries manage this in the presence of a hard budget constraint and limited external assistance? Which of the two should they prioritize and over what time frame?

Lessons from the staff paper would take us in one of two directions. One would be to promptly make "expenditure tracking" yet another and seemingly additional condition for reaching the completion point for HIPCs, which would effectively delay the delivery of HIPC debt relief, given that these countries lack capacity, as acknowledged in the papers. This would be the wrong approach, for at least four reasons. First, slowing down HIPC debt relief would set up the legitimate charge that we are changing the goal posts mid-stream. Second, improved expenditure management has already become an integral part of the conditionality either for HIPC or for the relevant PRGF program, and the conditionality for progressing to the floating completion point for most, if not all, of the HIPCs cite improved expenditure management as a specific conditionality. Third, early delivery of debt relief could augment resource availability and enable countries to embark on durable institutional improvements, including budget practices and particularly better systems to manage and monitor budgetary expenditure systems. Fourth, of course, development of effective expenditure monitoring systems is, to a significant extent, dependant on the individual circumstances, on a country-by-country basis. And judgment as to what constitutes a "proper" system tends to be better measured along a continuum, rather than as a discreet set of requirements for "proper" expenditure management. HIPC-eligible countries need improvements to their expenditure management systems in different degrees, and it seems that this point is recognized in the paper, though only in the last part of the document. The point would be better made if this aspect were brought out earlier in the paper.

The second approach would be to identify and provide the necessary financial or technical assistance to member countries, in the magnitude that will be necessary for them to fulfill the conditionality they have committed to as part of the floating completion point; and to provide the necessary resources to enable them to achieve substantially improved PEM systems in the medium term.

Finding and Strengthening "Interim Mechanisms" for Expenditure Tracking

The current paper is an important stock-taking paper and, in many ways, a reality-check paper, after the blistering pace in the last 13 months of first having established the PRSP, then its links to the PRGF, then achieved the 22 decision point cases. The finding that there are only 2 out of 25 HIPCs meeting satisfactory standards of expenditure management comes as no surprise to our Chair. The finding underscores the fact that a quick fix to the problem is not possible within existing capacity and resource constraints in these countries. Fairly late in the staff paper, the staff provide some suggestions for bridging mechanisms to address immediate need and highlight the importance of prioritization by the authorities themselves. These are good, but they involve additional financial resources and technical assistance, and they also imply the presence of additional administrative capacity when it is not clear how that additional capacity will be generated.

In the interim and until the resources are found and capacity is built, one seems to be led to the conclusion that there are effectively two existing mechanisms that could be explored and perhaps strengthened. First is the PRSP process itself. In focusing on tracking, we should not minimize the fact that the whole point of the PRSP process has been to devise poverty alleviation projects, ensure that such projects are funded, and monitor progress toward reducing poverty. The PRSP itself ought to be the proper mechanism for tracking expenditures rather than any new policy approach to this issue, as it is locally driven and enhances domestic ownership of programs. Again, of course, my comments are predicated on my lack of clarity as to whether expenditure tracking means anything more or less than expenditure management. I would appreciate the staff's clarification on the above. Second, donors are already active in many of the HIPC and PRGF/IDA countries and have well established mechanisms for channeling and auditing their assistance. In some countries, this might involve "Special Funds." Our Chair would much prefer a full budget process, and since this would enhance ownership and transparency, we can see merit in making use of an already existing channel that donors are already familiar with, which is well managed and which could give assurance that HIPC assistance is being used as intended.

Tracking Poverty-Reducing Expenditures

We believe HIPC assistance is only a fraction of, and in a number of cases, represents only a temporary flow of poverty-reducing expenditures. I therefore would like to emphasize, as the staff has done, that any expenditure tracking mechanism should be designed to look at the budget as a whole, rather than restricting the focus to the HIPC aspects only, and that as we tackle this matter, we should take a medium-term perspective.

We would like to underscore the important role that local governments play in enhancing domestic ownership and in implementing poverty-reducing programs. In fact, when discussing the limitations of monitoring local governments' operations, we face a dilemma. Strong domestic ownership of policies is a basic requirement for successful reforms, including that of the HIPC Initiative itself. However, such ownership, and indeed democracy, can only be effectively exercised and measured if at the grassroots level there is wide participation in the formulation and implementation of policies. The fact that we cannot envisage our assistance beyond Central Government level is therefore unfortunate. I would strongly support establishing mechanisms and provide the requisite very substantial financing and technical assistance to enable countries to track poverty-related expenditures at the sub-national level. The pace at which we expect the member countries to proceed should be conditioned on the extent of technical assistance and financial resources that are assigned to the task, by the members themselves, by the IFIs and by the donor community. We would very strongly urge the World Bank to strengthen its role in this area.

Measuring the Amount of Resources Available for Reducing Poverty

We contend that measuring such resources is a complex exercise. Nevertheless, we think that the point of departure is to assess whether the primary objective of the HIPC Initiative of reducing countries' debt burdens is being attained. The methodology suggested by the staff in paragraph 15 is appropriate, of ensuring that HIPC assistance leads to a net reduction in a country's external obligations, after taking into account the accumulation of arrears before HIPC and that HIPC translates into net cash benefit for the budget, thereby increasing the amount of resources available for reducing poverty.

In addition to the resources unlocked by the HIPC Initiative, the budget contains many other poverty-reducing expenditure components whose evolution needs to be assessed and monitored. However, the tension that has emerged in other countries between what can be strictly termed poverty-reducing expenditures vs. non-poverty reducing expenditures should be avoided, particularly given that such a distinction is not as clear-cut in the case of low income countries. The staff has mentioned that even using HIPC assistance to reduce domestic debt could be considered a poverty reducing measure under certain circumstances. I would agree with this; and I would even add that some aspects of security expenditures that help to enforce the rule of law and protect property rights as well as reduce the rate of crime contribute towards reducing poverty and particularly in low-income countries should be included in this category of expenditures.

The staff has mentioned the possibility of increased donor assistance after normalization of relations with HIPCs. However, such an assumption should be made with caution. Mozambique is a typical example that went through the HIPC process and experienced devastating floods, and yet a significant part of the donor pledges made at that time have not been disbursed, while the country is threatened with another round of floods. For many other countries, including Malawi and Tanzania, less than 50 percent of donor pledges translated into actual disbursements. Moreover, donor assistance usually takes the form of project assistance, of a short-term nature and tied to other non-economic conditions and some of it could be debt creating. It is therefore not always the case that when arrears are eliminated and Fund-supported programs resuscitated, donors automatically increase their support. If the case the staff is making is to provide comfort that resources will be forthcoming to address better management of poverty-reducing public spending, it is a poor case and unfortunately diminishes the powerful case that has been made–that we have gone much further than we ought to have in our requirements of the low-income member countries to improve their PEM systems, under the prevailing resource constraint.

The Importance of Technical Assistance

As mentioned, the findings in the staff paper about the poor state of PEM systems in HIPCs comes as no surprise to our Chair. We have been saying consistently and continuously that PRGF-eligible countries have generally poor expenditure management systems and that very substantial technical assistance needs to be devoted to building these. We have also consistently noted that the resources necessary for this are far beyond the means of most of the relevant authorities and that such a mammoth task will not be accomplished without a very substantial assistance effort by the Fund, the World Bank and others, notwithstanding the imperative for countries to own and spearhead their capacity building programs. The conclusion in the staff report that the Bank and the Fund have no substantive additional technical assistance for this exercise is particularly troubling. It is not a sustainable response and we need to find a better one.

The lesson take from this first reality check paper, is that we should recognize much more sharply the profound resource and technical assistance needs which will be required to correct the backlogs identified in the staff report. The staff paper also highlights what is for our Chair, emerging as an

> important consideration: that the inability to attract sufficient technical assistance resources to help HIPC countries in developing satisfactory systems, a requirement which is an embedded conditionality in all HIPC countries which have reached the Decision Point to date, will significantly hinder the effort towards poverty reduction itself. This would be a perverse outcome, since these countries have the will, but not the resources to achieve this important set of objectives.

Mr. Barro Chambrier supported Mr. Rustomjee's point related to the assessment of the conditionality for the completion point, which should take into account the reality in terms of administrative weaknesses in HIPCs, the forthcoming provision of technical assistance, and the absorptive capacity of each HIPC. It was important to take the individual circumstances of countries into account, and not to use the completion point conditionality as a way to delay the provision of further debt alleviation.

Mr. Bauche made the following statement:

> I think the report before us today is, unfortunately, a very accurate assessment of the capacity of budget mechanisms to track spending in HIPC countries. I say unfortunately because the staff's diagnosis shows that, despite many years of programs and of technical assistance, the very basic features of a public expenditure management system are not yet fully established in the countries under review today, and there are, indeed, a few reasons to think that the situation would be substantially different in other HIPC cases, or even other low-income countries. Therefore, I think that our approach should, in fact, be extended to all low-income countries, as stated earlier by Mr. Daïri.
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> Today's discussion is not simply a technical debate to discuss ways and means of putting into place specific benchmarks related to budget formulation, execution, and reporting. Today's discussion is a more fundamental debate on a core area of the Fund that encompasses such issues as governance, or administrative capacities, and even the effectiveness of Fund- and Bank-supported programs. In fact, it is difficult to see how the situation in HIPC countries could be significantly improved without the presence of more effective budget procedures.
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> Let me add that we should feel even more compelled to progress on those issues that the scale of the HIPC Initiative has increased the accountability of this Board, and we have a responsibility to put in place fiduciary safeguards within the debt relief initiative. I think Mr. Rustomjee and Mr. Barro Chambrier are quite correct in mentioning that in almost all past decision points, we have had budget conditionality in one form or another, but I would not even call that conditionality. I would call that very basic requirements to make sure that the debt relief is appropriately targeted to the right kind of expenditure. I suppose that what we are trying to do today is to find ways to help HIPC countries to fulfill those basic requirements.

Therefore, I fully support the realistic approach presented by the staff today, concerning the establishment of focused benchmarks and the upgrading of existing public expenditure management in HIPC countries. Those benchmarks are very minimal, but they are essential to lay the foundation of better public expenditure management systems. They strike a good balance between reinforced fiscal transparency needs and the constraint of insufficient administrative capacities.

Such upgrades, though basic, still require strong commitments from the concerned authorities in order to respect the proposed implementation time frame. Several speakers have emphasized the lack of administrative capacity and the need for more resources. Ownership is also of the essence. And they are right, as it seems that the Fund, along with other donors, has in fact devoted considerable efforts in capacity building over the years. For instance, I see from footnote on page 22 of the staff report that in fiscal years 1999 and 2000, about $250 million of World Bank investment lending was designed to provide technical assistance in public expenditure management. One could hope that such significant resources would yield more results and better coordination among technical assistance providers, and HIPCs must indeed be encouraged to maximize the benefits of technical assistance. But, I also agree with the staff on the proposed criteria to prioritize resources for public expenditure management assessments.

Let me add that France is already devoting a fair amount of technical assistance in HIPC countries, and that my authorities would see merit in increasing their coordination with the Fund and the Bank in order to better utilize existing resources.

I can also go along with the principles spelled out by the staff for better expenditure tracking. We also agree with the staff that the use of separate poverty funds could aggravate problems of transparency and of governance. Other mechanisms, such as virtual poverty funds, are more in line with the HIPC Initiative philosophy and, more generally, with the basic principles of sound and transparent budget management. I would, nevertheless, hesitate to continue to use the somewhat misleading adjective "virtual" for such funds, but I have no satisfactory alternative.

Finally, I agree with Ms. Lissakers and Ms. Redifer that this report is probably still a working paper, since the tracking of poverty-related expenditures in HIPC countries is itself still a work in progress. I, therefore, agree with the chairman's proposal to edit this paper somewhat, and I look forward to the next report. I would expect that it would spell out more precisely the road map to achieving better budgetary benchmarks, with intermediate steps and short-term bridging mechanisms.

Mr. Guinigundo made the following statement:

On behalf of our constituency, let me say that, in previous Board meetings, we have emphasized the need to establish tracking mechanisms, particularly in HIPC countries, to ensure that resources are utilized for the intended purposes. In this connection, we strongly support the staff's proposal for a general approach to develop systems that would track the composition of overall government spending on poverty-related programs. The paper illustrates the complexity of managing and monitoring public expenditures. The system to be established, therefore, should be able to address the difficulty of defining poverty-reducing programs on a country-specific basis, and the need for an effective government accounting and audit systems. These are specific requirements, and therefore the staff should be able to inform the Board in the future how to go about them. Moreover, recognizing that poverty-reducing spending is usually devolved to local governments, we see the need for the Fund and the Bank to introduce procedures that would be able to track spending patterns by governments at the subnational level. The paper also highlights that only a few HIPC countries have the appropriate system in place to implement public expenditure management. We therefore agree that the short-term approaches, such as the use of a virtual poverty fund or an alternative concept, or a simple "before-and-after" approach as suggested by the staff, could be put in place, provided that these will be consistent with the long-term goal of building efficient PEM systems. Again, the staff should be able to tell the Board how the specific short-term approach will be worked out to establish its consistency with the long-term goal. More importantly, countries must own the reform program in capacity building in whatever approach that is to be used.

Considering the differing degrees of needs in various HIPC countries, the majority of which require substantial capacity building, it is important that development partners work together to develop capacity and assist with institutional and governance reforms. We strongly support continued cooperation between the Fund and the Bank in providing assistance to HIPCs, particularly in areas where they possess comparative advantages. We also encourage them to work with other multilateral and bilateral partners too meet the capacity building demands facing the HIPCs. In the longer term, perhaps the Fund can consider expanding PEM assessments to cover countries other than the HIPCs, as this system would significantly improve transparency and accountability. We view the current working arrangement between the Fund and the Bank as adequate in bringing about the objectives of poverty reduction and sustained growth. While we view the task of building PEM capacity in the HIPCs as core Bank/Fund business, we only urge that care should be taken to avoid any duplication of work that may arise in the course of implementing the task. More information should also be provided on the resource demand for the Bank and the Fund to complete the work. Finally, my authorities would also suggest that in addition to the proposed criteria for allocating resources to strengthen PEM capability, we may perhaps need to estimate the relative contribution that the HIPC program could make in helping reduce poverty with priority assigned to those where the greatest benefit can be derived.

Mr. Maino made the following statement:

This Chair has had a long-standing record of supporting the strengthening of institutional capacity to formulate and implement good policies, and these includes judicious tracking HIPC assistance to ensure progress in poverty allocation. Although the latter falls clearly within a country's responsibility, we see ample room for the international community to collaborate in the development of comprehensive budgetary systems as part of an ongoing process of structural reforms and capacity building. When discussing the Proposal for Streamlining Preliminary HIPC documents, we put emphasis on the need to assess the efficacy of public spending.

Improved strategic implementation and effective allocation of assistance is a learning process for the entire international community. From a fiduciary perspective, donors need assurances that resources released under the HIPC Initiative will be allocated to poverty reduction. Recipient governments need to allocate and implement public expenditures consistently with the poverty reduction strategies they formulate. Safeguarding HIPC resources, therefore, requires donors, recipient countries, and international financial institutions to work jointly in the provision of the needed technical assistance. It is in this respect that we very much welcome the efforts made by the staff to advance a set of conceptual issues and to assess with realism the capacity for tracking spending in HIPCs.

The challenges and tensions inherent in this process are evident. The international community has concurred in the need to provide relief so that HIPCs could articulate their meaningful poverty reduction strategies, knowing that their institutional capacities to manage budgetary resources would require adequate formulation, execution, and reporting procedures. The poor institutional capacity of HIPCs to manage budgetary resources, flagged in Boxes 2 and 3 of the staff report, should come as no surprise, and we welcome a pragmatic approach for tracking poverty related spending in the HIPCs and monitoring the impact of such spending. We hope that monitorable key actions will be maintained to gauge how resources are used for additional poverty spending. This said, now let us turn to the issues for discussion.

On the general approach, we share the staff's view that tracking government spending on poverty remains the country's responsibility. An all-inclusive approach to budgetary spending targeted to poverty reduction is needed to assess the HIPC impact. We agree with the rationale that an institutional poverty fund would only provide a partial and narrow perspective. Similarly, due to non-standard definitions, lack of appropriate budget classification, and deficient government accounting and audit systems, the identification of poverty spending becomes cumbersome. A separate fund impairs accurate monitoring of additional spending on poverty programs. At the same time, as expressed by Mr. Daïri, it is important that the level of debt relief be clearly indicated in the relevant IFI documents, while, where there are arrears on debt services, the most appropriate approach calls for tracking total net external flows.

On the short-term approach, we endorse the short-run approach to monitoring the overall composition of spending and selected poverty programs. When assistance is provided in the form of general budget support, donors must rely on the public expenditure management (PEM) system in the recipient countries, while the first best solution would be that offered by the Medium-Term Expenditure Framework (MTEF), not only to track spending but, most importantly, because of its all-inclusive expenditure classification. In the presence of precarious budgetary systems in HIPCs, the availability of multi-year projections and the "before-after approach" advanced by the staff provide a pragmatic second best solution. The paper notes that, among HIPCs, the problem of tracking poverty-reducing spending has been addressed by "tagging" budget line items and by providing a subsequent virtual poverty fund. In this sense, we assign particular importance to also advancing output indicators in order to gauge dynamically the impact of such spending. This suggests the importance of a case-by-case approach for expenditure reporting.

On technical assistance, the availability of adequate financing to build-up capacity to track spending under the enhanced initiative remains our principal concern. We strongly support the provision of technical assistance in order to increase budgetary effectiveness. The Fund and the World Bank should continue to encourage HIPCs to undertake an improvement of their PEM systems and link the process to an actual estimate of the potential needs for further IMF and WB technical assistance missions and resident experts.

On cooperation between the Fund and the World Bank, the continued cooperation between the Fund and Band staffs is essential, based on respective clear identification of the responsibilities to avoid duplication and overlapping assistance. The joint work of Bretton Woods Institutions should also be expected to help focus the assistance of MDBs and external partners as well as bilateral donors to improve budgetary effectiveness. On the proposed criteria, we find that the staff has struck a reasonable balance between speed and quality to allocate scarce resources for strengthening PEM capacity. We, nevertheless, agree that an optimal allocation criteria should be based on country demand, need as assessed, and evidence that the assistance will be put to good use.

In sum, the Fund and the Bank should continue to take a pragmatic approach that builds on existing PEM systems in heavily indebted poor countries and provide the institutional incentives to facilitate implementation of the more robust MTEFs and advance capacity building more generally.

Mr. Daïri noted that Mr. Maino had referred to the issue of tracking effective debt relief, while the staff had presented the case where there was no direct benefit to the budget from the debt relief, which, in some cases, accrued to the central bank. That assumption should not be allowed, as any debt relief should benefit the government directly, with the appropriate arrangements being in place to ensure that it took place. If the debt relief went through the accounts of the central bank, it might take one more year for the benefits to materialize, and there was also the problem of fungibility of resources, whereby those resources might be used for other purposes.

The staff representative from the Fiscal Affairs Department responded that the staff report discussed the debt relief that would accrue to the central bank in the case of non-CFA franc countries, and raised the question whether that money should be transferred transparently through an account in the year in which the debt relief was received. The report pointed out that in the absence of such arrangement, transfer of HIPC assistance might be obscured and would be affected with a lag when the profits were transferred to the budget. To ensure transparency, a number of countries—such as Uganda and Tanzania—had accounts set up for the transfer of the debt relief to the budget in the year that debt relief resources were received.

The Acting Chairman confirmed that there was a mechanism for transferring the debt relief immediately, without having to wait for another year.

Ms. Bonomo made the following statement:

Today's discussion is very important, since tracking poverty-related expenditure supports the ultimate aim of the HIPC Initiative, which is tilting the composition of overall spending toward poverty reduction programs. The staff rightly points that out in paragraph 1 of the staff report.

I will first comment on the survey and its results, and then point out some lessons for future cases (that have not yet reached decision point). Third, I will comment on how to move forward with the current cases that are already past the decision point; and, fourth, I will make some remarks on the general conditions for the success of reforms.

I welcome the staff's survey of current practices of public expenditure in the HIPC countries, and I am grateful for the frank assessment by the staff on the possibilities and limits of tracking poverty-related expenditure. The present staff paper shows—not completely surprisingly—that much work is required, both of the multilateral institutions and the countries themselves, if HIPC resources were to be allocated effectively for measures of poverty alleviation. Since HIPC assistance is being granted to many HIPC countries already now, that work warrants the attribute “urgent.”

The results of their work point to deficiencies in most countries. Deficits are particularly serious in budget execution and in the auditing and monitoring of budget outcomes. According to the staff report, most countries’ budgeting and expenditure systems require substantial improvement before they have the capacity to effectively track public expenditure. In order to ensure the success of the Initiative, a speedy implementation of possible improvements will be vital.

A final remark on the survey: I fully support Ms. Lissakers’ and Ms. Redifer’s position that “the discussion on suitable interim tracking mechanisms to address immediate needs would be greatly facilitated by more country-by-country information.” I would have appreciated the identification of the countries surveyed. While I concur with the staff that too much ranking among the countries should be avoided, more detailed information would be useful. We should at least know in which broad category the countries fall. I, therefore, strongly suggest that the staff would provide us soon with a list according to Chart 2 that indicates which country needs little, some, and substantial upgrading of its systems for tracking poverty-reducing spending. This would not pillory countries but help us to assess where the country stands, its problems, and its need for technical assistance.

I turn now to lessons of this survey for future HIPC cases. Although this Chair has stressed the issue of budget management frequently in the context of the HIPC Initiative, it seems that we should have paid even more attention to this matter in the formulation of completion point conditions. There are some countries where completion point triggers do not mention public expenditure management. In the future—I would request—measures to improve public expenditure management should be included in the completion point triggers for all countries. I support Mr. Bauche’s remark that these measures constitute basic requirements.

Ideally, countries should have sufficiently strong PEM systems to effectively channel funds to prioritized areas already at the decision point. If that is not possible, they should have at least a proven commitment to undertake the necessary upgrading of their budget and expenditure systems until the completion point. Completion point conditionality should be employed in these cases as an additional incentive.

In hindsight, a survey of the PEM systems of HIPCs should also have been conducted at an earlier stage. I wonder—and would be grateful if the staff could elaborate on this—whether there are prospective HIPC cases where such a survey still needs to be done, and if yes, whether this work is already on its way.

On how to move forward with current cases, I agree on the following principles for tracking, as proposed by the staff. I agree that it is essential that not only HIPC funds, but all public expenditure for prioritized sectors is tracked. Moreover, I agree that the increase in external flows due to the regularization of creditor relations should also be reported to show the fiscal impact of HIPC assistance. This would also be important to communicate the impact of the initiative to civil society and political groups in the country, and would thereby foster support for the Initiative.

In the medium and long term, not only poverty related expenditure has to be tracked, but a comprehensive budget is needed, ideally in an MTEF. It is also important that ways will be found to assess the effectiveness and social impact of spending. All this would increase the effectiveness of future aid flows. In the short term, however, this might be an overly ambitious objective for many HIPC countries.

I turn now to what we can, and should do in the short term. I support that poverty spending is tracked by using multi-year fiscal scenarios or simple before-after comparisons, and by tagging budget items there seems to be no viable alternative. HIPC countries that do not yet have satisfactory budget classification systems to allow tagging should, therefore, as a first step, address this problem. At the same time, I would like to stress that the staff and the Board should closely monitor how much effort the HIPCs will make to improve their budget systems and statistics. This is part of the HIPCs' contribution for making the HIPC Initiative a success. The credibility of the Initiative will be put at risk, if there were a lack of effort in this important area. Moreover, this has to be the focus under PRGF-supported programs.

In addition, I would suggest that the staff reports on the progress of expenditure tracking in HIPCs in adequate length in the PRGF reviews. I would also very much welcome a general review of the problems of expenditure tracking in HIPCs, as a follow-up to this report, in due course. Furthermore, contrary to the staff, I believe that the tracking of expenditure at the subnational levels should already be attempted in the short term for those cases where the bulk of social expenditure takes place at this level, as the staff mentions in paragraph 9. Finally, I would like to ask the staff to clarify the following point: Could it happen that HIPCs, whose completion point triggers do not include budgetary management items, reach the completion point without making any progress in tracking poverty-related expenditures? Would they then still obtain a full debt relief?

Finally, let me offer some comments on general conditions for the success of reforms for better expenditure tracking in countries. First, it is clear that the HIPCs must have a strong commitment and a high degree of ownership to implement the necessary institutional reforms. Steps to increase the transparency and accountability of government spending are only likely to be of lasting effect if the request for their improvement is voiced loudly enough within the respective country. Second, since participatory decision-making mechanisms on public expenditures can be very useful and effective in reducing poverty, I encourage the staffs of the Fund and the Bank to assemble best practices in this field. Third, it is evident that HIPC countries need much technical assistance on budget management over the next years. I agree that the demand for technical assistance by donors and the Fund should come from the countries themselves. The Bank, the Fund, and bilateral donors have a crucial role in granting TA, and the coordination of their activities is essential. I also agree on the staff's proposal to prioritize TA. Fourth, on collaboration, there seems still to be room for improvement in the collaboration between the Fund and Bank staffs. Just an example: the number of missions to the HIPCs should be limited, not least in order not to absorb too much resources in the HIPCs. This is crucial, since it seems to be a defining limitation to a speedy progress.

To conclude, tracking of expenditure will remain an important issue for discussion for some time ahead. I think that we should discuss progress in countries individually, but also have soon another general discussion similar to this one, based on more detailed information. Like Mr. Pickford, I hope that finalized assessments of each country's situation will have been concluded soon, preferably earlier than at the end of the year.

Mr. Nijsse made the following statement:

Let me start by saying that we broadly support the way forward on this subject as proposed by the staff. Transparency and accountability of government spending is vital for the credibility and public support of the HIPC Initiative. Therefore, I agree with Ms. Lissakers that the tone of the paper should be more encouraging for countries to implement better budgetary management systems to be able to track poverty-reducing spending.

I strongly agree with the staff that tracking of poverty-reducing spending should be included in the normal tracking and control procedures with regard to the budget. I also agree that creating institutional poverty funds would only create new bureaucracy, decrease transparency, and lower the credibility of our calls for a comprehensive budget. We should also be careful to require too advanced management information systems and too detailed information, specifically aimed at poverty-reducing spending, from countries that do not have enough capacity to implement advanced systems. Furthermore, the staff clearly describes the problems related to the measurement of poverty-related spending. The benchmarks used by the staff seem to strike the right balance in this respect.

I believe that the measurement of the results with regard to poverty reduction of government budgetary policies, should remain aimed at the medium-term PRSP targets. Of course, also a certain level of short-term accountability with regard to poverty-reducing spending should be ensured. Like I said before, this would preferably be included in the normal public expenditure tracking and reporting process. With regard to that, I agree with the staff that in countries where a medium-term expenditure framework is absent, the IMF's and the World Bank's own multi-year fiscal scenarios and a simple before-after approach can be used. However, we should not reduce our efforts to implement adequate general public expenditure management systems in all member countries.

I agree with the staff that effective public expenditure management is not only important at the national level, but at the local level as well. However, priority should be given to comprehensive budgetary management and control systems at the national level. Only if those are effective and well functioning, Fund and Bank assistance should be directed to assisting the local level. The Fund's focus in particular should first and foremost be macro-oriented, while the Bank could give additional assistance at the local level.

I agree with the staff that countries should be encouraged to seek technical assistance in building a Public Expenditure Monitoring system. This is not a requirement that is valid only for HIPC countries though. It is simply a pre-requisite for any effective budgetary process with adequate evaluation and control mechanisms. I fully support the close cooperation with the World Bank in this area, and I agree that bilateral donors and other multilateral organizations could be important sources of technical assistance with regard to capacity building in HIPC countries. I can assure you of the continued support of the Netherlands' authorities in this area.

Mr. Faini made the following statement:

We are grateful to the staff for this paper that provides useful hints on how to deal with the issue of tracking poverty expenditures in a context of limited institutional capabilities. This issue is of the utmost importance: only an efficient and effective channeling of overall resources available to poverty reduction will uphold the premises of the HIPC Initiative. Only a serious tracking effort will assure the general public that resources are being well spent.

Unfortunately, on the tracking front a lot remain to be done. Few countries will be able to perform satisfactorily in tracking and reporting by their completion point. The bulk of the HIPC countries will still face difficulties over the medium term (that means, beyond the expected completion point). We agree with the staff that the right approach should combine pragmatism in the short term with a view to strengthening the Public

Expenditure Management capacity over the medium term. We hold however the view that, especially for countries with serious weakness in their Public Expenditure Management system, ambitious short-term measures are important, since they can be reassuring with regard to the good use of resources.

From a medium-term perspective, we believe that the point that tracking should be comprehensive and not limited to the HIPC assistance is well taken. Both fungibility and the fact that HIPC assistance is a very small subset of the overall resources potentially available strongly argue for a comprehensive approach. A full-fledged tracking exercise should allow for monitoring the use of HIPC and other external resources, and for disentangling how the HIPC Initiative has triggered a shift in the overall composition of public expenditure toward poverty-reducing spending.

Given the current shortcomings of the Public Expenditure Management systems, a short- term pragmatic approach seems to be unavoidable. We agree that short-term devices should be consistent with overall long-term objectives. We want to stress however that serious measures to tackle the difficulties of the PEM system should be put in place as soon as possible. In particular, we strongly expect visible improvements by the completion point. Moreover, we would attach much value to actions signaling that matters are progressing in the right direction. To this aim we would support having a full report on the use of interim assistance by the completion point, even though we reckon that the information value of this report could be limited. It goes without saying that any information that will allow a meaningful assessment of the shift in the composition of public spending under way would be appreciated.

An important outstanding issue is how to identify poverty expenditures. While some expenditures (like basic education and health care) are likely to appear in all countries, some others could vary considerably from country to country. Expenditures should be classified as poverty-reducing on the basis of the country’s poverty reduction strategy, which should in turn be based on a sound poverty assessment. Such a reliable strategy, however, has unfortunately been far from standard in a number of HIPCs. That is to say, progress on strategy, which should definitely be made by the completion point, would deliver important results on the tracking front as well.

Another difficulty is with devolution. On the one hand, it is clear that emphasis on services provided by local governments could help to fill the gap between government and the needs of the people. On the other hand, devolution will certainly make tracking more complex. On balance, we are of the view that some basic conditions on fiscal soundness should be in place before any attempt to decentralize expenditures is made. On this front it would be interesting to know from the staff whether the experience of some countries so far might allow us to draw some preliminary lessons.

We are glad that the point of appropriately measuring the HIPC assistance is recognized as important. We agree that resources freed by the HIPC Initiative should be transparently identified. We also agree that the impact of the Initiative should be considered from both the commitment and the cash viewpoints. Emphasis should be placed on net transfers and in this context an effort should be made to disentangle actual cash debt relief (i.e. reduced debt service due to the accumulation of arrears should be explicitly mentioned). It would also be appropriate to show how the HIPC Initiative has contributed, apart from an increase of external flows, to a better coordination of aid flows.

In line with the original design of the Enhanced-HIPC Initiative, a full tracking exercise should include an evaluation of the overall impact of spending on poverty. This should be regularly done on the basis of outcome indicators, and the relationship between spending and results should be transparently reported. While we understand that this is a medium-term challenge, we still believe that the effectiveness and quality of spending will be key for the overall success of the Initiative. We would like to see the emphasis on output indicators explicitly recognized in PRSP documents. Accordingly, we would expect a clear reference to the effectiveness of public spending in the tracking exercise.

Mr. Rustomjee observed that a number of Directors had mentioned correctly that there was a basic element in conditionality, or a basic requirement in the PRSP process, which was that countries should pay greater attention to good budget management. That required considerable resources. Also, there was a trade-off between devoting those resources to better budget management and to other elements of the interim, floating completion point conditionality. If a country were required to focus on strong budget management systems not just for HIPC-related or poverty-related expenses, but for all budget expenditures, then it would cost even more to develop such systems. As many Directors had pointed out, the cost to achieve that basic standard was considerable, and it drained resources from other aspects of conditionality included in the floating completion point document. A logical conclusion to that would be to start dropping some of the conditionality, and to attach higher priority to the conditionality related to the issue of better budget management.

Ms. Lissakers remarked that the question of tracking outcome or effort vis-à-vis expenditures was a complex issue, but to cite an example, educating girls could have positive externalities for poverty reduction over time, although there was no measuring system to immediately determine whether, in any given country, those externalities were realized. As mentioned in the staff report, a tracking or reporting system might not be in place to determine if the most pervasive weaknesses concerned budget reporting and an inability to validate reported budget outturns. There should be an alternative way to track whether there was, in fact, an increase in the enrollment of girls, which marked the first step to increasing girl education. That should be measurable simply through sampling in communities, without the help of a sophisticated, comprehensive computerization of the budget and the budget outturn. There were primitive methods of tracking whether or not a positive step had been made on the ground before a comprehensive plan could be put in place.

Mr. Daïri considered that the breakdown of budget systems was probably the most severe risk facing any poor country. He agreed that there was room for strengthening management systems in the short-term, keeping in mind the need to ensure that those developments were sustainable over the longer term, and that countries' capacities were not stretched too far so that there was a risk of retraction at a later stage. Therefore, technical assistance should be covered within a program, with long-term commitment from the international community.

Mr. Josz made the following statement:

> Reducing the external debt of the poorest countries to a sustainable level is only an intermediate goal of the HIPC Initiative. The ultimate goal is to reduce poverty, inter alia, by creating room for additional spending to reduce poverty. Tracking poverty-reducing public spending in HIPCs is, therefore, crucial for the successful implementation of the HIPC Initiative.
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> Tracking only poverty-reducing public spending financed by HIPC assistance makes little sense. These expenditures only amount to a small fraction of total government spending. There is a clear need to upgrade the tracking of all public expenditures in all HIPCs. As part of an overall strategy to drastically improve public expenditure management, all poverty reduction strategies should make satisfactory progress in this area.
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> Ms. Lissakers's comments about the lack of intermediate steps to improve public expenditure management systems in the staff report offer very useful guidance to further work at the country level. All PRSPs should include a clear assessment of the deficiencies of budgetary procedures, and a path to upgrade these procedures to the benchmarks identified by the staff as sufficient to track poverty and other expenditures with a reasonable degree of confidence.
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> As for the trade-off presented by Mr. Rustomjee—between poverty-reducing expenditures and expenditures to upgrade budgetary procedures—I would tend to think that the two must go hand in hand. To have good budgetary procedures is so important to the overarching goal of reducing poverty. I can understand why some would say that if we switch from PRSP toward improving the budgetary systems, faster progress could be made. However, I do not think that we would want to go that far. The staff report makes us aware that it is important to have a medium-term strategy to improve the budgetary procedures and it is in that framework that perhaps more focus is needed in the PRSP. Without that, it would involve a huge shift

of resources from social expenditures to those for improving the budget information systems.

The establishment of poverty funds to account for the use of HIPC assistance is only second-best to a reliable public expenditure management system. In the short run, in the absence of reliable public expenditure management systems, the Fund and Bank staffs will need to continue to adopt pragmatic approaches to tracking public expenditures financed by HIPC assistance. Poverty funds may be necessary as a first step to make sure that HIPC assistance is productively spent in countries where public expenditure management systems are currently highly deficient. But, at the same time, the authorities should design and implement a medium-term strategy to address the deficiencies of their budgetary procedures. The Fund and the World Bank should clearly take a proactive approach to encourage countries to undertake public expenditure management assessments, and enlist support of bilateral donors and other multilateral institutions to support HIPC efforts to improve their budgetary procedures. The Fund and the World Bank should delineate their respective areas of intervention. The Fund should continue to assist the ministry of finance in designing and implementing strategies to improve the overall budgetary process. The Bank should assist other ministries to improve their budgetary procedures, and the Ministry of Finance in the installation of computerized information systems, compatible with the overall strategy designed with Fund assistance.

I agree with the criteria for allocating technical assistance spelled out in paragraph 39 of the staff report, with one caveat. Countries that made poor use of technical assistance in the past should not a priori be excluded from further assistance. If they demonstrate strong political will to redress their budgetary procedures, inter alia, by explaining the lessons that they drew from their failure to make good use of technical assistance in the past, these countries should also be considered for further technical assistance.

Mr. Wei made the following statement:

At the outset, let me thank the staff for providing a very useful paper for today’s discussion. Like others, we agree with the staff that it is necessary to establish an appropriate tracking of poverty-reducing public spending in HIPCs. We also share the view that the task of tracking public spending on poverty is the responsibility of individual countries. In this respect, we agree with Mr. Daïri that “the onus is on individual countries that have received international assistance to adequately assure the international and donor communities that the resources have been utilized as intended.” As we broadly share the thrust of the paper and share the views as expressed in the statements of Messrs. Shaalan, Djojosubroto and Daïri, as well as the views of Messrs. Barro Chambrier and Rustomjee, I will make two brief remarks on the key issues raised in the paper.

First, the authorities of HIPCs are encouraged to make their utmost efforts to build or improve their tracking mechanism on poverty-reduction spending. While we would stress the importance of support and assistance from the international community, the ownership issue should be kept in mind, since the establishment of the tracking mechanism involves many government agencies. Without the active involvement of all parties, it will be difficult to imagine the tracking mechanism will be effective. As pointed out by Mr. Daïri, HIPC assistance is not always delivered in the form of additional resources, but often in the form of debt-stock reduction and rescheduling. In this connection, like many others, we find the "before-and-after" approach practical and appropriate.

Second, as recognized in the paper, HIPCs generally have weak institutional capacity to implement the fiscal and monetary objectives included in the program. All of us agree that this could only be improved through technical assistance provided by IFIs, including the Fund. It is not realistic for a country to enhance its institutional capacity overnight as the TA process is time consuming, particularly in training officials. In this respect, we agree with Mr. Shaalan that the 4-5 " person years" increase for this purpose projected by the staff is on the low side. We also agree with him that every effort should be made to streamline the documentation so that the staff resources could be better utilized on the most important and urgent issues confronting member countries. We also call on the international community to increase their contribution of financial resources in support of countries that are making efforts to strengthen the tracking of poverty-related spending. Like others, we hope that additional work on tracking poverty-related spending does not affect the core responsibility of providing technical assistance to members in general. Needless to say, the importance of Fund/Bank coordination and cooperation cannot be overemphasized, especially with the staffs of both institutions making their utmost efforts to avoid overlapping on conditionality. In any circumstances, the proposed requirement for improvement in tracking poverty-related spending should not become an additional conditionality for HIPCs to receive debt relief.

Mr. Fenton made the following statement:

I would like to thank the staff for the constructive paper before us today. As Mr. Barro Chambrier and Mr. Rustomjee have emphasized, it should not come as a surprise that most HIPC countries have serious capacity problems in the area of expenditure management, but it is sobering nonetheless to see the magnitude of the challenge spelled out in the staff paper. That being said, we have no choice but to address it. Improving governance in HIPCs, as all the I-PRSPs to date have emphasized, is a top priority and strengthening public expenditure management is central to this effort. I would like to associate myself with Mr. Rustomjee on the need to be sensitive to the implications of this for countries' ability to achieve the triggers for the floating completion point. I also agree with Mr. Bauche that country ownership is essential.

We support the staff's suggested approach of a virtual fund to track additional poverty-reducing expenditures made possible by the Enhanced HIPC Initiative, while proceeding with a medium-term plan for strengthening public expenditure management systems. Given the initial conditions, a virtual fund that tracks the evolution and composition of poverty-reducing expenditures from before the decision point onward is the best that one can do; however, we should recognize its limitations. It is a measure of the change in these expenditures through time rather than a decomposition of the use made of the change in the total net external flows to the budget as a result of HIPC. Also in implementing a virtual fund, the quality of the results will depend on the criteria used to tag spending as poverty-reducing, as Mr. Rustomjee noted, and it would be helpful if these criteria were applied consistently across countries. The staff paper gives the useful example of the different possible classifications of rural roads. But this gets into the issue of country ownership. There is also the possibility that a country might wish to tag something as poverty-reducing that the staff does not agree is poverty reducing. How will we handle such a case, if one should arise? Also, is this approach feasible in the countries that have substantially decentralized their social spending? And how long will it take before estimates start to be available?

Finally, we agree that IMF/World Bank assistance efforts should aim in the medium term to help establish mechanisms that would also enable the tracking of poverty-related spending at the subnational level, and to help countries develop the means to assess the effectiveness and social impact of such spending.

Mr. Pickford made the following statement:

Like others, I think this is an important paper and I welcome it. I think it is another piece of evidence of the usefulness of joint Bank-Fund efforts in this area. For the record, I agree with the principles set out in the paper, and endorse the recommendations and agree with the suggestions made in the issues for discussion. I think one of the benefits of the discussion we have had so far is that it has produced a very strong measure of agreement around the table about the way forward. On the principles, for instance, I think there is considerable agreement that using preexisting systems or virtual tagging, where necessary, is far preferable from the point of view of developing public expenditure management capacity in the medium term. I think we have given a clear message on the issue about separate institutional poverty funds, and that is useful.

On the approach in section 3, I fully agree that we need to build on existing systems and be consistent with the long-term objectives for capacity building. The action plans also need to be paced based on the country's absorptive capacity, and should fit into the institutional environment and use the authorities' relevant institutions—for example, where they have these bodies, the accountant general, or the auditor general. I think the aim throughout this process must be to harmonize as much as possible the external monitoring and audit processes around the country's own systems, because, in the longer term, we need to build up those capacities.

On the issues for discussion in the paper, I think it is right that the approach to public expenditure management improvements needs to be comprehensive and not focused just on poverty-reducing expenditures. And, the Bank and the Fund clearly need to work closely together in countries by, in the first instance, pulling together their various diagnostic tools and assessments, of which there is quite a range of, sometimes overlapping. I think it is important that the two staffs have a clear view of their appropriate division of labor, and to ensure that their technical assistance and strategic advice on public expenditure management is well coordinated and consistent across the two institutions.

I also agree it is important to look at the subnational level, though, like Mr. Faini, I think we need to recognize that there are difficult issues involved, and progress may have to take sometime to reach a satisfactory level.

On the resource issue that a number of Directors raised, I view the issue of public expenditure management at the heart of a sustainable growth process for countries and therefore part of the core mandate of both the Fund and the Bank. Therefore, I would need to be persuaded before concluding that the two institutions need additional resources. There may be some reprioritization required.

Mr. Rustomjee asked whether we should advise countries to spend on poverty or on upgrading public expenditure management systems. I think this is too stark a contrast. Like Mr. Josz, I think public expenditure management improvements are a key investment for countries, which can quickly improve the poverty-reducing quality of spending. I note, for instance, that Uganda early on in the process took the decision to devote 5 percent of its poverty reduction fund resources to improving financial management systems. I think that probably will have turned out to have been a very wise investment.

Nevertheless, I agree that more resources will have to be devoted by the international community to this issue. And, just to reiterate what I said earlier, where other bilateral and multilateral institutions have value to add to this process, we should work with them and take advantage of the resources they bring, in terms of both the assessments they can offer and technical assistance. Like a number of other speakers, my country would be happy to participate in that process. In addition, I think it would be helpful if the staff could comment on how bilaterals could be better involved and integrated into this process of capacity building.

Still on the subject of assessments, I think it is important that public expenditure management should become a greater or more integral part of Fund surveillance work. The fiscal transparency code is a start, but there is an urgent need to address the issue of the implementation of budgetary processes. A first step would be to set out country-owned and specifically tailored annual action plans for each HIPC, based on clear assessments of need, and of how to improve public expenditure management in critical areas for success. I do not think this can be a one-off initiative. It will take time and patience and country commitment, as a number of speakers have stressed.

I think it has to become part of the annual cycle of assessment in each country, which then leads on to action to build capacity. I think the process of PRGF annual reviews provides an ideal structure for such benchmarking.

Finally, I would like to suggest that the group of both the Fund and Bank staffs—the working group that prepared this analysis—should come back to the Board as soon as possible and, as I stress, certainly well before the end of this year, with an outline mapping out how the two institutions intend to proceed country by country. Also, it may want to take the lead in considering how to best involve willing donors.

Mr. Junguito made the following statement:

The staff paper presents a bleak, but, unfortunately, realistic picture of public expenditure management systems in HIPC countries. The problems in poverty expenditure management (PEM) are several, encompassing budget formulation, execution, reporting and auditing. They involve not only the central government but also sub national governments, which account for a growing share of poverty-reduction spending in about a quarter of the HIPC countries. The problems go beyond those associated with institutional and capacity weaknesses.

We agree with the staff that the initial step is to accurately measure the resources that are being released by the HIPC Initiative. It is only when the country is current with its payments that real resources are freed by debt relief.

We note in footnote 6 in page 6 that for 2001-05 the annual HIPC cash assistance for 22 countries that reached the decision point last year is only 2 percent of GDP, which represents less than 8 percent of overall public expenditure in these countries. Given the size and nature of the problems described by the staff and the relatively small amount of HIPC assistance in relation to total public expenditure, we still ponder whether, as a first step, it would not be preferable to adopt a pragmatic short-term bridging approach of tracking only HIPC funding instead of all public spending.

The main objection to such approach is that money is fungible and it could not guarantee that HIPC resources are additional to previous or intended poverty-reducing spending. It may be possible, however, to try to complement this approach, as a less formal second step, with a broad comparison of the overall level of poverty-reducing spending before and after the HIPC program.

A special fund encompassing only resources released by HIPC would have the advantage of giving a clear response to the political and public opinion questions of where the HIPC money was spent. The staff comments would be appreciated relating to these issues.

We agree, however, that whatever short-term approach is used, one confined to HIPC released funds or the more complex one of trying to encompass all public spending, such short-term approach would have to be complemented with a medium-term framework designed to strengthen the budgetary and public expenditure management systems in HIPC countries.

Whatever the short-term approach, there are a few important comments that we would like to underscore.

First, it is important to avoid a narrowly construed definition of what are poverty reducing expenditures, as pointed out by Mr. Rustomjee. Primary education, basic health care, low cost housing, water, sanitation, and rural development would seem prima facie to qualify as poverty reducing expenditures. But investment in physical infrastructure may also have a major impact on poverty reduction and should be so classified. This can only be decided at the country level and according to each country's circumstances.

Second, it is very important to notice that many HIPC countries have already been substantially increasing poverty reducing expenditures under the original HIPC and this should be taken into consideration. Guyana is a case in point.

Third, we fully agree with the staff that the most important element of this effort is that programs to increase the capacity of public expenditure management should be owned by the countries concerned.

Fourth, it is very important to be realistic and pragmatic and keep the short-term tracking system simple. Even with countries' full commitment, the staff's expectation that significant improvements should be established by the completion points seems to us unrealistic.

Fifth, the need for technical assistance to the HIPC countries is enormous and cannot be overemphasized. We repeat our earlier calls for a substantial increase in IMF technical assistance to deal with this initiative. We support Mr. Barro Chambrier in that the track record should not be a variable. We must carefully consider during the budget allocating more of the redeployed the staff to the PRGF/HIPC initiatives.

After adjourning at 12:30 p.m., the meeting reconvened at 2:00 p.m.

Mr. Alosaimi made the following statement:

I thank the staff for a well-written paper on tracking of poverty-reducing public spending in the HIPCs. The fiduciary importance of the effort is evident since the promise to channel net resource gains to poverty reduction is at the heart of the HIPC Initiative. This is indeed a very difficult task. I agree that at this stage, priority should be clearly on the best possible measures within existing capacity and resource constraints. I will add a few comments in that context.

I endorse the strong case the paper makes against the so-called institutional poverty funds approach to the tracking of pro-poor spending. Indeed, there are limits to even the virtual poverty fund approach that the staff suggests. The paper has ample examples of the difficulties in identifying the poverty reducing potential of various spending categories. The links between public spending and poverty reduction also vary from country to country and over time. Here, I look forward to a greater understanding of the issues from the work continuing in the context of the PRSPs. The most that can be expected meanwhile is an informed view on whether the trend in public spending has in fact become more pro-poor. Like Mr. Rustomjee, I see a need for the proposed tracking to be in line with the work on PRSPs. Indeed, this will strengthen the ownership to poverty reduction.

The HIPCs understandably lack the tools necessary to track how that assistance moves through the economy. Indeed, an adequate spending management system in that regard will be a challenge for even the economies far more advanced than the HIPCs. Also taking into account Box 1 and paragraph 30, clearly the only pragmatic approach at this stage is to build on the existing system and to make simple "before-after" comparisons as set out in paragraph 21.

While I agree that the HIPCs should have a stronger capacity to track poverty reducing spending, the broader focus should be on the need to strengthen the monitoring of overall budgetary developments. A highly developed poverty related module is unlikely to be effective within a greatly inadequate budget monitoring system. In view of the capacity limitations typical of the HIPCs, it is thus important to avoid any excessive stress on a stand-alone poverty-tracking module, as it can be disruptive to the broader budgetary reform process.

In most cases, the fiduciary assurance that we seek would thus require a substantial commitment of additional technical assistance. I therefore agree that the staff should continue to work with the country counterparts on the needed technical assistance.

Finally, I agree to continuation of Fund-Bank cooperation as proposed, in view of the joint strategy for implementing the HIPC Initiative.

Mr. Fidjestøl made the following statement:

I will be very brief as I am in general agreement with the approach outlined in the paper. I will concentrate my comments on two issues: the short term goals versus the medium-term goals and the resources implications for the Fund.

First, since a majority of the HIPCs almost per definition have poor public expenditure management (PEM), significant work is needed to bring these countries to an acceptable minimum. In this respect, I find that the outlined end-goals in the staff report are very reasonable. As the staff points out, however, it will not be easy to meet these goals and it will take time. It is therefore necessary that some more obtainable and short-term-oriented goals are laid out. In this respect I am a little bit more in doubt. On the one hand, I fully agree with the staff's reasons for refusal of separate institutional poverty funds. On the other hand, the staff seems to advocate a virtual poverty fund as an intermediate or short term tool. To my mind, a virtual poverty fund has many of the same weaknesses as an institutional fund, in particular with respect to the fiduciary perspective. Also, too much work on a virtual poverty fund could risk tying up limited administrative resources in work that is not fully consistent with the medium-term goals.

In my view, the short term goal should primarily be geared towards the development perspective and not so much the fiduciary perspective. In this respect, a virtual poverty fund could have its merits, if it can facilitate a greater cross ministerial coordination and prioritization. In this phase, I believe the World Bank has a greater role to play than the Fund. To cover the fiduciary element - which is equally important - in a satisfactory way, more capacity and institution building is needed, in particular with respect to independent auditing. This will take more time.

Second, on the resources implications for the Fund, while a properly working PEM is extremely important, this must be considered within the framework of our budget discussion, where this chair has taken a restrictive position. I do not see that additional Fund staff resources are needed, in particular in the light of last year's large budget allocation to the HIPC area. Moreover, tracking of poverty reducing public spending is predominately a World Bank matter, in particular with respect to the development perspective.

Mr. von Kleist made the following statement:

The staff paper for today's discussion is well written and candid. Due to the latter, it leaves the reader with a sense of frustration. Even though many, if not most, of the HIPC cases have received international support for many years, the public expenditure management systems obviously are still woefully lacking, even though after this morning's discussion the picture looks a little bit brighter than in the staff report. The paper provides valuable insight into the difficulties confronted by the Bank and the Fund while supporting HIPCs and ensuring the accountability and impact of poverty-related spending. I broadly concur with the staff's recommendations, with some minor caveats.

We support the view of the staff that the tracking exercise is critical with regard to the envisaged shift toward result-oriented and more efficient public spending. Similar problems will certainly be encountered also in other low-income countries, a point which was first made today by Mr. Daïri. The problem addressed in the paper has at least two dimensions. One is the formal dimension, which relates to formal accountability and auditing procedures. Here, we face capacity and organizational issues, compounded in many cases by broader governance problems, including corruption. A lot of experience has been gained already in this area through the work of the Bank and the Fund, as well as other donors.

The other one is the substantive dimension of the problem. The definitional identification of poverty-related spending requires an ex ante understanding of the causes and nature of poverty in any given country. Obviously, there is a strong link between country-specific poverty analysis and ex post expenditure tracking—a link that also underscores the benefits of close cooperation with the Fund, as Mr. Pickford has already mentioned. Furthermore, the prevailing understanding and empirical as well as theoretical definition of poverty will affect the design of expenditure tracking and result monitoring. Since PRSPs are to be revised after three years and the country's perception of the causes of poverty might change over time, we should be aware of the dynamics of this exercise.

Obviously, the tracking of the composition of overall government spending on poverty-related programs is superior in many ways to a more narrow approach of tracking only HIPC assistance. Unfortunately, however, as the paper points out, the development of such a comprehensive system may take years, with an uncertain outcome, if we judge by past performances. On the other hand, one of the central pillars of the HIPC Initiative, and Ms. Lissakers has also made this point, is the understanding that resources freed by debt relief will flow into poverty reduction. The political consensus that supports the HIPC Initiative rests on this linkage.

This dilemma can be overcome by a pragmatic case-by-case approach. If a comprehensive expenditure-tracking system is not within reach in a period of 6-12 months, partial solutions will have to be installed in the meantime. Obviously, a resource constraint on both the country and the donor community—including the IFIs—will, in some cases, necessitate less than perfect solutions. To reduce pressure on the country's administrative capacities, priority should be given to coordinating, to the best extent possible, the numerous advice-giving activities of the IFIs and bilateral donors, as other speakers have commented.

The overall policy objective of Fund involvement in any member country is to reach a sustainable balance of payments position within a framework of macroeconomic stability and satisfactory growth. Within this overall objective, resources freed by debt relief should be seen to reduce poverty. While each case is unique and flexibility is certainly needed, I would prefer HIPC resources to support measures that have a direct impact on poverty above measures with a more indirect impact, such as those that generally support growth.

Whether a virtual poverty fund, a separate institutional poverty fund, or some other alternative is superior has to be decided on case-by-case basis. But, at least, a rudimentary expenditure-tracking system should be available everywhere.

Mr. Yanase made the following statement:

I generally concur with the staff analysis and proposed approaches. I also support a rewriting of the staff paper as suggested by the Chairman. Thus, I will focus my comments on a few issues.

First, on collaboration, no one will deny the importance of collaboration with other institutions and donors. Nevertheless, to improve effectiveness, collaboration must go hand in hand with a clearer division of labor. Otherwise, attempts to enhance collaboration will lead to more confusion and resources wasted in an effort to coordinate many players. I appreciate this morning's staff clarification on the role of the Fund, and I hope to see it included in the paper when it is rewritten. It is important to publicly clarify the Fund's role, so that the Fund's staff, including that in the field, will know what they need to do, and other institutions will understand what they can expect from the Fund.

Second, on technical assistance, I also agree on its importance. However, we should not forget that HIPCs are not the only countries that request technical assistance. It is clear from our discussion on technical assistance last month that the demand for TA is far greater than the supply. It is impossible to provide all the necessary TA even for HIPC countries. Therefore, I strongly encourage the staff to be selective in providing TA, using the four criteria presented in the staff report.

In addition to the choice of HIPC countries, we must also face a tough decision on how much TA resources should be spared for HIPC countries as a whole. In doing so, I believe the judgment must be based on the effectiveness of TA in achieving macroeconomic stability, which is the Fund's TA goal. If a TA project in HIPC countries does not contribute to macroeconomic stability relative to other projects for other countries, the TA should not be provided.

Lastly, I agree with those Directors who argue that effective expenditure tracking is a general basis for HIPC assistance. I hope the staff could continue assessment work as fast as possible, and incorporate their results to country-specific programs so that we do not need to wait for this paper to be updated, which includes all countries.

Mr. Zakharchenkov made the following statement:

We broadly endorse the staff's analysis and recommendations to strengthen the fiscal framework for tracking poverty-reducing public spending, as presented in the paper. In light of the comprehensive discussion, which already took place at the Board, I will try to be brief and, in my statement, I will address only some specific issues.

First, I fully agree with Ms. Lissakers and other directors that the paper lacks clarity with respect to what can be done in the short term to address existing deficiencies in the public expenditure management systems (PEMs). The staff simply says that this is a complicated process, which is likely to take considerable amount of time, thereby putting more emphasis on the medium- and long-term perspectives. While I broadly concur with this notion, it seems that some changes are needed sooner rather, and the paper does not address this issue deeply enough. I agree that, where possible, one should build adequate PEMs on existing systems. But where such systems are unavailable, there should be a strategy of how to proceed starting from now with intermediate benchmarks to monitor progress and proposed bridge mechanisms to put in place, pending the development of a more comprehensive PEM system.

Second, on the issue of resources, the paper says that this is the countries' responsibility to track poverty-reducing spending. It also clearly states that additional resources and implementation capacities are needed to upgrade existing systems. The report, however, does not say where these resources will come from, except general reference to donor community and bilateral creditors. We do not have a remedy to this issue. But this situation calls for efficient utilization of technical assistance (TA) provided by the Fund and the Bank. Here, we agree with the staff that TA should be provided primarily to best performers, i.e., countries that demonstrated effective use of TA in the past. At the same time, like several other directors, we call upon the staff to apply judgment and understand individual circumstances of each particular country. No country should be banned from further provision of TA based on the Fund's past experience.

Third, the proposed approach implies identification and tagging of poverty-reducing spending in a virtual poverty fund. Here, our concern is what will be the staff's approach for identifying spending on poverty-reducing programs. This is a complicated issue because of the unique determinants of poverty in each particular country and, therefore, unique priorities set in individual PRSPs. Some spending is likely to be country specific. This issue was comprehensively addressed by Mr. Rustomjee. Therefore, I welcome the staff's response that the staff will be selective in their considerations and the proposed approach does not imply general blueprint for identifying poverty-related spending.

Fourth, the proposed approach is likely to be time and resource consuming for the Fund and the Bank. Therefore, it is necessary to make a clear division of labor between the two institutions. The Fund's responsibility should be tracking of general composition of spending at the national level. Any tracking of spending at the subnational level (which is already a necessity in some HIPC countries) and any structural issues which will inevitably arise should be in the Bank's domain.

Finally, I agree with the proposal to somewhat brighten the report. The report, as it is drafted now, gives the impression that it came as a revelation that most HIPC countries do not have adequate PEM systems in place. This may provoke general public to make a judgment that multilateral institutions were unaware of the problem and were not doing their best to address this issue. Moreover, by making a statement that little, if any, can be done in the short-term staff is sending a misleading message to the HIPC countries which discourages them to proceed promptly with PEM systems upgrade. Like other directors, I favor a redrafting of some parts of the report.

Mr. Daïri remarked that, as had been indicated by Mr. Rustomjee and Mr. Junguito, the expenditure-tracking exercise was needed to take account of a country's specificities, as to how reduced poverty might differ from country to country. He supported the proposal to focus on the aspects of expenditure that increased the incomes of the poor and allowed access to basic resources. One methodological issue that needed further clarification was whether or not the staff had a threshold for the contribution of each expenditure type to the reduction of poverty, above which monitoring would be required. In his view, even if the expenditure itself did not contribute significantly to poverty reduction, it should be tracked. Also, the staff and the authorities needed to have sufficient criteria for assessing ex-post how much each type of expenditure contributed to the reduction in poverty.

Mr. Djojosubroto made the following statement:

> We agree with most of the comments made by other Directors. We endorse the principles laid down in the staff report for tracking the HIPC-supported poverty-related spending. We particularly endorse the general approach that the overall compilation of government expenditure needs to be tracked to assess effectiveness in reducing poverty. However, tracking poverty-related expenditure alone is not sufficient. What is important is to have a mechanism in place to ensure that countries make speedy progress toward poverty reduction and growth.
>
> We have no objection to the idea of having benchmarks. In this context, we see the merits of having some benchmarks, which could be flexibly considered on a case-by-case basis, to assess the effectiveness of government spending on poverty reduction, including the new HIPC assistance. This should not, in any way, constitute conditionality.
>
> Given the limited capacity and resource constraints of many of these countries, it is only through additional donor support for the capacity building efforts, including through a more coordinated approach by the Fund and the Bank, that they can put in place effective mechanisms for public expenditure management system and governance reforms. We hope that such assistance would be forthcoming.

The staff representative from the Fiscal Affairs Department, responding to the questions from Executive Directors, made the following remarks:

> I will first take up the question that was raised by Mr. Junguito on why we should not focus narrowly on HIPC assistance for tracking purposes. This may not be a good idea for two reasons. First, focusing exclusively on HIPC assistance will not capture additional spending on poverty-reducing programs, as resources are fungible and the country can offset HIPC assistance earmarked for poverty-reducing programs by lowering its own spending in these areas. Second, HIPC assistance constitutes a small portion of both revenue and public spending in these countries, and the expectation is that poverty-related spending would increase in most HIPCs, given that the PRSP process is according higher priority to poverty-reducing programs.
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> The second question that was raised by Mr. Rustomjee was on the trade-off between strengthening public expenditure management systems and increasing poverty-reducing spending. We believe that this trade-off may not

be as stark, as already pointed out by Mr. Pickford. First, the surveys that have been carried out to track the use of public money have shown that, in the absence of good PEM systems, resources may not reach their intended beneficiaries of how tracking surveys can be used to improve the share of expenditure going to the poor. Uganda is cited as an example in the staff report. And, second, increasing poverty spending may not necessarily improve outcomes, if the money is not spent efficiently. Hence, an improvement in PEM systems can increase the effectiveness of existing public resources. It is for this reason that many HIPCs are planning to carry out expenditure-tracking surveys.

The third issue that was raised was on the countries that have trigger points in the public expenditure management area at the completion point. Out of 22 countries that have reached the decision point, 16 have triggers that require some strengthening of public expenditure management capacity at the completion point. And, virtually all of the countries that require substantial improvement are in that group, and almost all that require some improvement are covered in these trigger points. The countries that require little upgrading do not have those triggers. So, for the countries that are not covered in these trigger points presumably, at the time when they reach the completion point, they have to demonstrate effective implementation of the PRSPs. In that context, there would be an opportunity to assess whether the PEM system can ensure that HIPC assistance is being used effectively. Some trigger points call for comprehensive budget execution reporting, others require the publication of quarterly budget execution reports, and, in some cases, the development of a medium-term expenditure framework. All these improvements can help in strengthening public expenditure management in HIPCs.

The Acting Chairman recapped that currently, there were 16 countries with PEM measures included as completion point triggers and with definite improvements being required in the PRGF arrangements. In addition, two countries already had relatively satisfactory PEMs. Of the 16 countries, nine would require major improvements based on a long-term commitment and considerable effort.

The staff representative from Fiscal Affairs Department said that, on subnational spending, there were only six countries in the sample of 25 countries surveyed where more than 10 percent of the spending on poverty-reducing programs was being undertaken at the subnational level. This number was expected to increase, however, that clearly pointed to the need for strengthening PEM systems at the subnational level.

Regarding Ms. Lissakers's question on the availability of data for evaluating some of the outcomes, such as girl enrollment in schools, such data were being produced independently of the development of public expenditure management systems, the staff representative noted. A number of PRSPs had established goals in terms of such intermediate targets, and those were being monitored in the context of both the PRSPs and international development goals.

In defining the type of spending to be included in the budget for monitoring purposes, the objective was to track the spending that was identified in the PRSPs as poverty- reducing, but that would vary depending on country-specific definitions, the staff representative indicated.

The second staff representative from the Fiscal Affairs Department said that a number of Directors had raised the question on whether bridging or short-term actions should be more clearly specified in the staff report, the staff representative observed. By definition, a bridge represented the idea that one would move from point A to point B, crossing over the bridge at some point in time. It would, however, be more appropriate to consider the issue at hand in terms of a spectrum, as data were not sufficiently available to identify either the full mechanism or specific points along the bridge. There was only a minimum amount of data existing in 1-2 HIPCs that would permit effective tracking, while the goal was to enable all countries to reach the far end. Before determining the way forward, each case needed to be reviewed to grasp a better understanding of the existing—particularly absorptive—capacities. The idea of bridging mechanisms was well taken and should be explored further. At the current stage, only functional data were available for most countries, while, ideally, each country should have a program classification and intermediate accounting framework. In 23 of the 25 cases, there was scope for improvement, and that would be a priority area.

On the distinction to be drawn between expenditure tracking and expenditure management, as raised by Mr. Rustomjee, the definition of "tracking" had changed over time, the staff representative noted. While the starting point had been to track HIPC resource spending, a more general problem of public expenditure management had gradually emerged, which needed to be addressed in the context of a medium-term action plan. That area, therefore, had become the focus of technical assistance. The exercise had progressed—on the part of both the Fund and the Bank—from tracking the input at the first stage toward tracking the outcomes and impact on social indicators and poverty, all of which were part of tracking. After the assessments of the 25 HIPCs had been completed, the staff would also assess other countries as they came on stream.

Efforts were being made to pull in the support of the bilateral and other donors to help upgrade PEM systems in HIPCs, the staff representative continued. The Fiscal Affairs Department had eight resident experts, and a number of technical assistance missions focusing particularly on those tracking issues. There was also considerable Bank investment and activity by the individual donors. While such assistance was helpful, coordination was of importance to avoid duplication or an excessive burden on the individual countries. The staff had recently held discussions with the European Union about its trust fund proposal, which would help to enhance some of the activities necessary for upgrading PEM systems. There had also been a meeting of the Special Program for Africa, which had brought together many donor countries, the Bank, the Fund, and the European Union, and reached a clear understanding of what needed to be done. Moreover, France and the United Kingdom had indicated their readiness to lend support. The challenge would be how to coordinate efforts in order to achieve the goal.

The Acting Chairman asked whether an HIPC country could reach the completion point without having an adequate public expenditure management system in place, a question raised by Ms. Bonomo.

The second staff representative from the Fiscal Affairs Department replied that, each PRSP would specify a set of specific programs that needed to be undertaken to relieve poverty, a review of which would be done within a year to assess whether the tracking mechanism had been in place. In that sense, it would be very difficult for a country to reach the completion point without having gone through that process and without a review that would have identified problems and the areas in need of technical assistance.

The Acting Chairman clarified that, in most cases, there was specific conditionality on measures that needed to be taken to improve public expenditure management systems, while in others where it was difficult to track what was happening with spending, the review process would capture that problem.

The staff representative from the Fiscal Affairs Department elaborated that there were two mechanisms—one was the review; the other, provided that the Board approved of the proposal in the staff report, was the action plans, in which weaknesses and remedial measures would be identified.

The Acting Chairman reminded the staff of Mr. Daïri's question as to whether monitoring should apply to the overall anti-poverty spending or just HIPC resource spending.

Mr. Daïri said that, in addition to that, he had also asked the staff to clarify what the term "significant contribution" of expenditure to poverty reduction meant, and what the criteria for the selection of expenditure programs for monitoring purposes were.

The staff representative from the Fiscal Affairs Department responded that there was a problem in defining expenditure programs—especially in the infrastructure area. As seen in the PRSPs, while some programs such as primary education and basic health were identified as poverty reducing by all countries, others, such as communications and roads, were classified as poverty reducing only in some PRSPs. All spending defined as poverty-reducing in PRSPs would be tracked.

The Acting Chairman noted that Directors seemed to have different views on that; some clearly preferred to count only the more direct expenditures. As for the word "significant, " judgment would be exercised.

The staff representative from the World Bank remarked that there seemed to be considerable agreement among Directors regarding the importance and complexity of the topic. Directors also broadly supported the need to tackle the whole budget and to move forward in a collaborative way. The staffs of the Fund and the Bank had worked together over the past six months to complete the task.

The idea of the reality check was worthwhile and budgetary expenditure allocation and tracking spending were major issues, the staff representative noted. In a narrow sense, tracking meant financial management aimed at tracing where the money was actually spent; that was already a major issue. As referred to in the staff report, in the case of Uganda, the staff had visited schools and hospitals, and had learned that only a third of the money allocated—non-wage expenditure—had actually reached its intended beneficiaries. That percentage was, however, increasing steadily with intensified efforts over the past few years, but it remained a major problem. That suggested that the standards or benchmarks specified in the staff report were fairly modest. There were many other areas that needed to be tackled. For example, the staff had not yet addressed some of the core issues of decentralization, which were considered important by some Directors. More would need to be done in that area, as currently there were only six countries that were moving rapidly enough to decentralize their economies. The staff would also need to address the difficult question of the impact of spending—whether the additional money would actually lead to better development outcomes. In the areas that had already been covered, there remained major hurdles, and thus the reality check would be useful.

Second, the staff held a rather optimistic view, as over the last 3-5 years, the amount of work on public expenditure management and institutional reform had risen exponentially and would remain central to the work of the Bank, the staff representative continued. The President of the World Bank had recently mentioned that those issues were at the top of his agenda—governance and institutional reform, including public expenditure management as one subset. Outside the Bank, the Fund had also been active, and other bilateral donors and multilateral institutions had put considerable effort in this work, which altogether could make a difference.

However, it was difficult to chart out mechanistically the way forward as each country was unique, especially in terms of the entry points, the staff representative pointed out. The staff had taken a country-by-country approach, for example, to assessing the governance situation, identifying the partners and the entry points, and designing an action plan together with country authorities. It would remain rather country-specific, which was a major challenge. The timing was appropriate for linking this process to the PRSPs, and the Bank staff was working closely with the PRSP team to bring these issues into the PRSPs. Similarly, they could be incorporated into the HIPC completion point discussions. The linking process would depend on the decision of the two Boards.

The demand side would also need to be considered, as the type of demand and the capacity to move forward would vary from country to country, the staff representative said. Each action plan would have to be calibrated to meet the specific demand and fit the capacity in each country. There was no one-size-fits-all model. In sum, the whole process was very country-specific and the major challenge was to move forward, taking into account the demand and the linkages with the PRSPs and the HIPC completion points.

Third, on the way forward, the main question was the time frame, the staff representative added. While it would be desirable to complete the task at hand as soon as possible, it might not be practical, considering the amount of work and the number of people across departments involved, both in the Fund and the Bank. It was a considerable managerial job even within the Bank alone, while this matter involved the Fund, other donors, and multilateral organizations. For example, the follow-up on a country-by-country basis comprised three tasks. First, the simplest, was to refine the assessments. Second was to consider the way forward in each individual country, building on what had already been done. Third was to coordinate efforts among donors in each country. Each step in each of the 25 HIPCs took some effort and time, and might involve several visits. A one-year time frame, as proposed, had been considered carefully, and had been accepted within the Bank up to the senior management level. Also, it would fit within the Bank's budget process. The staff would report back to the Board by the end of the 2001 calendar year with full action plans for all 25 countries.

On the complementarity of work, the Bank was more medium-term development-oriented, with focus on institution building, while the Fund was more short-term macroeconomic focused, which was appropriate, the staff representative concluded. In terms of instruments, technical and financial assistance was also complementary between the Fund and the Bank. In a wider context, the European Union had participated in the coordination effort by setting up a trust fund, together with key bilateral donors, particularly France and the United Kingdom, which might participate as founding members. Negotiations were under way to set up a mechanism that would improve donor coordination going forward. Further discussions on the follow-up plan, in terms of both assessment and technical assistance could be brought up in subsequent periods.

Mr. Rustomjee thanked the Fund and Bank staffs for their comprehensive responses, and remarked that he was pleased to note the clarification that tracking could be viewed from either a narrow or a broader perspective. It seemed clear that the broader view had been taken in this context, which pointed to the enormous resource need in each HIPC, both to tackle the tracking problem and to address the substance of poverty reduction in general. It was not clear, however, how HIPCs would receive those necessary resources; that became a matter of concern. As noted by the staff representative of the Bank, these were major issues and would take a long time, even on the basis of the narrow definition of tracking poverty-reducing spending. It would thus be helpful to understand from the very beginning how tracking was defined. From the perspective of the HIPCs concerned, the staff report confirmed that there was a big unsatisfied resource requirement, which was a source of concern.

Mr. Rustomjee admitted that the trade-off between poverty-reducing spending and spending on improving public expenditure management systems was not so stark. The trade-off was not an issue of one choice being better than the other, as both were the right choices for policy makers. However, the staff report seemed to present that there was a resource constraint to improving PEM and reducing poverty, while, at the same time, HIPCs were asked to press strongly ahead with poverty reduction through the HIPC and PRSP process. Where to obtain resources to address those problems remained an important question, to which the staff report did not respond. Mr. Pickford had raised the interesting example of Uganda, where part of the interim and bilateral debt relief provided to Uganda during the interim period had been specifically spent on building PEM systems. Such a process took a long time to materialize—nearly seven years. This was a case for accelerating the provision of debt relief so that HIPCs could have the resources necessary for the improvement of their PEMs more quickly. In the case of Uganda, the country had not had the resources to deal with PEM and poverty reduction; therefore, upon receiving the interim debt relief, a portion of those resources had been used precisely for that purpose.

Mr. Rustomjee then asked, in the context of the budget, whether the Fund had made any provision for the resources to deal with the implications of those problems. Mr. Fidjestol had expressed his view that the Fund would not need additional resources for that particular purpose. At the same time, the Fund considered this issue essential and central to its work in HIPCs. The question remained as to whether the Fund was making resources available for such an activity, in particular if it were to extend beyond the HIPC cases, perhaps to all PRGF cases. The Board had recently discussed the staff report on the budgetary framework, which showed little additional resource being allocated to the departments that would have to bear most of the burden—the Fiscal Affairs Department, for example—if this issue were to receive priority. A problem might arise in the future, unless the resources had been set aside internally. Admittedly, much of the work would have to be done by the Bank, but there was more than just the residual that the Fund would need to take on.

Mr. Rustomjee concluded that, unless the resources were readily available in the 2001 budget, HIPCs would likely request that the Fund limit structural conditionality in the floating completion point documents, so that more attention could be paid to improving public expenditure management, before progressing subsequently on other structural conditionality. Such an option was not preferable, but unavoidable if the required resources were not provided by the Fund.

Mr. Barro Chambrier noted that the process seemed to be more complicated, especially as explained by the staff representative from the World Bank. Apart from the conditions required for the floating completion point, in most HIPC cases, there were many requirements imposed at the same time—to upgrade PEM systems; to have the action plans, which would take considerable time, while the specified time frame was only one year; and to implement the PRSP. There was also the issue of resources, and the need to manage those resources from the World Bank. All those appeared to be detrimental to HIPCs, which were not in a position to fulfill all of the requirements already in place, unless technical assistance was forthcoming in a timely manner.

Mr. Pickford added that he had a similar point on the timing. While recognizing the work involved and the importance of the issue, he was not convinced that there had to be a management process for the whole system. By necessity, the action plans would have to be drawn up country-by-country; some countries were well advanced in their assessment of what needed to be done and the detailed interventions that might take place. The Fund and Bank staffs needed to go back to the country level and discuss this with country authorities during the regular review missions. The pace of progress might differ from country to country, and there was no reason to manage the process as a whole. That would cause unnecessary delays and jeopardize the potential gains that HIPCs should be able to realize in terms of improving the quality of public expenditure through better PEM systems that would, in turn, improve the quality of the impact on poverty. He expected regular reporting to the

Board, both in the context of PRGF reviews and in terms of comments on PRSPs, as the situation developed. On both occasions, this issue should be flagged, and reported on at a different level, depending upon the pace of progress in each country. It was important to make as much progress and as quickly as possible.

Ms. Bonomo, recognizing the time required to finalize the assessments, commented that the staff should provide the Board with more detailed information—for example, a list of the countries classified by broad category regarding the degree of improvement needed. That information would be useful for future discussions on this topic.

Ms. Lissakers commended the staff for the rigorous approach to this exercise, and for the candid presentation. The Board discussion, however, seemed to exaggerate, to some extent, the magnitude of the resource challenge to make meaningful progress, first of all in terms of meeting the core requirement of the HIPC Initiative. She was concerned by the comment from the Bank's staff about the amount of time needed for coordinating the work between the Bank and the Fund, and between the Bank and Fund and other IFIs and bilateral donors, which would delay the whole process. In identifying what each country needed to do or could do, and mapping out an individualized action plan, both the Bank and the Fund could simply send five people into the field and design a plan. There was no reason to waste so much time in coordination. Rather, implementing the plan would be more resource-intensive.

U.S. legislation required the Treasury to certify that a country receiving U.S. support for concessional financing from the Bank and the Fund had a process of auditing and reporting military expenditures to civilian authorities, Ms. Lissakers said. The United States and, more importantly, the Bank and the Fund had worked with countries in an effort to establish and operate such PEM systems. It might be too early to assess how effective those systems were for monitoring, but a credible monitoring system had to meet a minimum standard.

With regard to the staff report, Ms. Lissakers stated that it was important for the report to be a reference point, not only for the Bank and the Fund, but also for the donors and, more importantly, the HIPCs themselves, civil society, and other groups that were actively involved in the areas of public expenditure and poverty reduction in HIPCs. Therefore, in the absence of a country-specific plan, the staff report should at least provide some description of a road map to guide HIPCs—in particular the 16 countries—toward meeting the full standards.

Mr. Daïri agreed with Mr. Rustomjee that if the HIPC Initiative were to be used as a leverage for strengthening budget management, that leverage should be made stronger, with faster and more generous debt relief. Second, if it was agreed that the task of tracking government spending on poverty was the country's responsibility, there might be room for more discussion with the member countries before drawing any firm conclusions, especially with regard to the general direction of where and how to proceed. Thus, the current process should be seen as a work in progress that needed to be revisited sooner than in 12 months, as indicated by the staff representative from the World Bank. At that time, the needs of the member countries and their coordination of technical assistance would also have to be considered.

The second staff representative from the Fiscal Affairs Department, in response to Ms. Bonomo, explained that the staff report was somewhat reticent in giving details about individual country positions, as it might strike a delicate balance. It would be dangerous—and prejudicial to the whole process—to conjecture on the basis of preliminary information, which was largely derived from desk assessments. Moreover, as country ownership was essential to the implementation of the action plans, agreement and common understanding of the problems had to be sought from country authorities.

Ms. Lissakers, asked if she would wish to have the interim steps clearly specified in the staff report, said that the staff report should both spell out the interim steps, especially for the 16 HIPCs, and also indicate the steps that were being taken. Her concern was more on the structure of the staff report, which tended to send out a negative message. Paragraph 30 of the staff report stated that only two HIPCs would be able to have an adequate tracking system in the foreseeable future; another seven would have some; while the remaining 16 were unlikely to achieve the goal of having PEM systems in the near future. That message, though representing only a fraction of the whole message of the report, would be captured by many readers, and jeopardize the credibility of the HIPC exercise as well as the Fund as an institution. Other facts should also be stressed—that progress was under way and that there were control and monitoring systems. Those benchmarks that were embedded in the HIPC documents were not given enough attention in the staff report. Therefore, the report needed to be revised before being distributed to the public.

The staff representative from the World Bank stressed that donor coordination was still a work in progress, and a lot more work needed to be done before the action phase could take place. All of the 25 HIPCs would have to be covered in less than a year, while the staff was currently taking on considerable workload. The challenge, therefore, was to have a better focus, with a holistic view, to identify the missing parts, to strengthen the efforts, to avoid overlapping, and to make the necessary adjustments as the process continued. That required a certain amount of consultations; such consultations should not be regarded merely as a bureaucratic exercise or a drag on the whole process.

Ms. Lissakers pointed out that, on the resource issue, consideration should be given to the redeployment of existing resources to minimize waste. There was enormous waste in the governments of HIPCs and, to some extent, in the Fund. The fact that the Bank and the Fund had allocated hundreds of millions of dollars to technical assistance for HIPCs, and later had discovered that they did not have in place the most rudimentary public expenditure management system, was troubling. No additional resources should be made available; rather, both the governments of the HIPC recipient countries and these institutions would have to manage their resources more efficiently by putting a control system in place.

The Acting Chairman remarked that he would not regard the approach taken by the institutions as being totally wrong or not addressing the right problem. Rather, the problem facing them was inherently more difficult than expected. It might be true, in some sense, that there was enormous waste. Nevertheless, operating through technical assistance was inherently difficult, as the solution was not known ex-ante. Countries, as opposed to the bureaucracy in those countries, should want technical assistance. There had been many cases in the past where the Fund had spent on technical assistance and had had a difficult time getting it accepted. If countries took it with absolute seriousness and had full control over their bureaucracies, it would be possible to just reassign resources. The notion that one could easily move societies by pouring in resources from outside was problematic, as evident in past experience. That, however, did not mean that the Fund or the Bank should take no action. On the contrary, the Fiscal Affairs Department and resident technical assistance would be made more available for that purpose. It was not simply a matter of changing priorities, or moving resources around to more efficient uses.

Mr. Rustomjee stated that the countries in his constituency would be contented with the redeployment of resources. On the government side, redeployment would go a long way in helping to reduce the significant waste that presently existed. There had been a major development in 2000—the PRSP process itself—which was not sufficiently taken into account. The whole PRSP process was supposedly for countries to determine their priorities and to map out their future path, including how to obtain resources and the financing for them. One of the early results of that PRSP process was exactly the point of the current Board discussion—a revelation that public expenditure management systems in those countries were not able to fulfill the objective of the PRSP process.

The Acting Chairman remarked that the staff paper would be rewritten to indicate more of what could be done rather than what could not be done, and to capture more of what was taking place—the virtual poverty fund and the focus on poverty spending, for example. The first part of the report would make it clearer that, although there were significant gaps in the process, progress was made.

The Acting Chairman made the following summing up:

> Executive Directors emphasized the importance of heavily indebted poor countries tracking all poverty-reducing spending to ensure that budgetary savings from HIPC assistance are being used as intended. Directors considered the tracking of HIPC assistance, as part of the wider tracking of poverty-reducing spending in general, was essential to ensure that resources being spent actually reached the poor and provided the intended benefits. They noted that it is also important for the credibility of the HIPC Initiative to provide assurances that debt relief, as well as concessional assistance more broadly, is being put to its intended use. In this context, Directors considered strengthening public expenditure management (PEM) an urgent priority to help ensure that the HIPC Initiative resulted in appropriate poverty-reducing programs.
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> Directors noted that, ideally, increased spending on poverty reduction should be assessed in relation to baseline multiyear expenditure projections in the absence of HIPC assistance. Realistically, however, such an approach

would not be feasible for most HIPCs in the short-term, and it may, therefore, be necessary for the authorities and the staff to adopt a simple "before-after" approach. Directors also agreed that, in the absence of a comprehensive PEM system, it could be appropriate to use a "virtual" poverty fund, whereby poverty-reducing spending identified in PRSPs is tagged and tracked. Care will be needed to ensure that all poverty-related spending is captured, whether by a virtual poverty fund or other means of classification. This will require a case-by-case approach, as what constitutes poverty-reducing spending will depend on the country's poverty reduction strategy.

Directors observed that, once poverty-reducing spending is identified, tracking it requires effective government accounting and audit systems. On the basis of the preliminary assessments of PEM systems in twenty-five HIPCs undertaken by the Bank and Fund staff, Directors expressed concern that most HIPCs do not currently have the capacity, as part of their PEM systems, to produce comprehensive information on the uses of HIPC assistance. In the majority of cases, substantial upgrading of existing systems appears to be required to attain this standard. While recognizing that developing adequate expenditure management in HIPCs will be an ongoing process that will take time, a number of Directors stressed that more can be done to strengthen public expenditure management in the short-term, with the view of helping to ensure that resources freed under the HIPC Initiative are appropriately used. In this context, they suggested that short-term "bridging" mechanisms for tracking, consistent with longer-term goals, could be implemented while effective and comprehensive PEM systems are being put in place. Directors considered that the authorities, multilateral institutions, and bilaterals should attach high priority to this.

In light of the fungibility of resources, Directors noted that tracking the use of HIPC assistance, for example, through an institutional poverty fund, would provide only partial information on aggregate spending on poverty reduction. Moreover, a narrow tracking of only one element of public spending (except in special circumstances) could undermine ongoing efforts to strengthen overall expenditure management systems. This underscored the importance of a broader approach to monitoring the use of HIPC assistance, and the need to track all spending aimed at poverty reduction, as well as its share in total government spending.

Directors stressed that while the responsibility for tracking poverty-reducing spending lies with national governments, the Fund and the Bank should be more proactive in encouraging HIPCs to review the preliminary assessments of their PEM systems, identify key weaknesses and map out action plans, which would be reflected in PRSPs and PRGF arrangements, to address those weaknesses over the short and medium term. Several Directors suggested that the staff and donors work with the authorities to establish a trajectory with realistic intermediate steps to help the countries meet their longer-term objective of putting in place strong PEM systems. This would facilitate the mobilization of international financial and technical support. These capacity-strengthening programs should build on ongoing PEM work being undertaken by the authorities with the assistance of the Bank and Fund, and on the important input of civil society in monitoring the use of resources under the process for formulating poverty reduction strategies. In this regard, several Directors underscored that the timely provision of adequate levels of technical assistance will be critical to help the authorities in their efforts in this area, especially in the short-term, and, more generally, to ensure the success of the HIPC Initiative.

Directors emphasized the importance of continued cooperation between the Bank and Fund, and with bilaterals, in PEM work in HIPCs, as well as the need to ensure consistent advice and avoid duplication. The division of labor between the two institutions should be in line with the traditional focus of the Fund on macrofiscal management, and of the Bank on structural and institutional issues related to poverty reduction and capacity building.

Noting the resource constraints faced by both institutions in the PEM work on HIPCs, Directors stressed that in allocating these resources, the staffs of the two institutions should take into account relative needs for improvements, as well as evidence of country ownership and the likelihood that the assistance would be put to good use. Directors also urged the Bank and Fund to work together with country authorities to generate additional support from other multilateral organizations and the donor community. While according this work the highest priority, a few Directors did not believe that a case had been made for additional resources, as work on creating PEM systems lies at the core of Fund and Bank activity.

Directors emphasized that most of the twenty-two countries that had reached the HIPC decision point have completion point triggers or program conditions relating to public expenditure management. For those few countries for which there is no specific conditionality on improvements in PEM systems, the PRGF review process would have to be used to ensure that sufficient progress in improving PEM has been made by the time the completion point is reached.

Directors also noted that in several HIPCs, subnational levels of government will play a critical role in implementing poverty reduction strategies. Therefore, assistance will need to be provided to these countries, especially by the World Bank, in establishing mechanisms to track poverty-related spending at the subnational level. Countries should also be helped to develop the means to assess the effectiveness and social impact of all poverty-reducing spending. This would be essential to determine whether the resources spent actually reach the poor, and provide meaningful benefits.

Directors also recognized that in most instances, establishing those systems would require time and resources, and that these considerations should be taken into account when designing Bank and Fund programs.

Directors noted that strengthening public expenditure management and tracking of poverty-reducing public spending was work in progress, and they welcomed the Bank and Fund staffs' intention to provide periodic reports to their respective Boards on the progress made by HIPCs in the areas outlined above, as well as reports of Fund and Bank work in this area. Regular reporting on the progress made by individual countries in improving their PEM systems would take place in the context of reviews of PRGF-supported programs and Article IV consultations. In addition, a comprehensive report will focus on the assessment of weaknesses currently hindering the tracking of poverty-reducing spending, on the steps envisaged by each country to address these weaknesses over the short to medium term, and on the assistance that has been provided as well as the technical assistance that will be required in this regard. Directors encouraged the staffs to make this work a priority and, if possible, to accelerate the expected timeframe of the end of this year for issuing the report.

3. TURKEY—STAND-BY ARRANGEMENT—REVIEW, AND WAIVER OF PERFORMANCE CRITERION

The Executive Directors considered a paper on the fifth review under the Stand-By Arrangement for Turkey and Turkey's request for a waiver of a performance criterion (EBS/01/8, 1/30/01; Cor. 1, 1/31/01; and Sup. 1, 2/2/01).

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

Turkey's strengthened program and the Fund's financial support are working well to restore market confidence.

Market Developments

On November 17, 2000, before the crisis struck, the overnight interest rate was 41 percent and the six-month T-bill interest rate was 40 percent. During the crisis the overnight rate fluctuated wildly, never falling below 90 percent and occasionally spiking as high as 1258 percent; and the six-month T-bill rate also climbed to over 100 percent. After the announcement of the strengthened program and the Fund's financial support, these rates declined, steeply at first and then more gradually. On February 1, 2001, the overnight rate was 35 percent and the six-month T-bill rate was 53 percent.

On November 17, before the onset of the crisis, gross international reserves were $27.4 billion. By December 21, they bottomed out at $19.3 billion, a cumulative loss of $8.1 billion. But on February 1, 2001, they had recovered to $25 billion, a gain of $5.7 billion. Admittedly, part of this recovery comes from the $2.25 billion borrowed under the SRF. Even so, Turkey's ability to attract, in a month's time, inflows of $3.5 billion over and above its large financing needs is encouraging. Only in the last two days of January was there some tension in the exchange market caused by an outflow of $811 million. But on February 1 and February 2, the direction of net flows reversed itself and the central bank was able to purchase $738 million. These outflows and inflows seem to result mostly from end of month adjustments in investment portfolios.

The improvement in Turkey's standing in the international markets allowed it to place, on January 30, an issue of three-year euro-denominated bonds worth euro 500 million at 390 basis points above German bunds. Although higher than the rates on previous Turkish issues, this rate is lower than those of bonds issued by comparable countries.

The Turkish authorities agree with the staff that it is too early for a reliable forecast of this year's slowdown in output growth. In any case, some kind of slowdown is probably needed to reverse the deterioration of the current account and ensure the attainment of the inflation target.

The sharp reversal of the yield curve during the crisis has inflicted serious losses on the banking and corporate sectors, and the continuing high interest rates add to the interest cost of the budget. The staff now estimates that this year's consolidated public sector interest payments will amount to 15.1 percent of GNP, which is 2.9 percent of GNP higher than estimated before the crisis, but still 0.5 percentage points lower than the original program estimate at the end of 1999.

Policy Implementation

The Turkish authorities are well aware that the situation remains fragile, and that the program must be implemented fully and on time, as has been and will continue to be the case. To boost market confidence, the program has been confirmed and even strengthened in four areas.

Monetary developments have turned out better than expected in December 2000. This has made it possible for the central bank to reverse, more rapidly than programmed, the buildup of its net domestic assets that occurred during the crisis. During the last five working days of January, the average stock of NDA had shrunk to TL -316 trillion, well below the program ceiling of TL 900 trillion.

Excluding the seasonal increases during the religious holidays, base money declined smoothly from TL 5,407 trillion before the crisis to about TL 4,500 trillion at the end of January. The stance of monetary policy can thus be seen as having favored the attainment of the inflation target, thereby allowing market interest rates to decline without danger to the exchange rate.

To make its monetary policy still more predictable, the central bank has decided to lower the NDA ceiling to zero for the test dates of end-February, end-March, and end-June. This will involve reductions of TL 800 trillion, TL 650 trillion, and TL 200 trillion respectively (where TL 100 trillion equals about $150 million). By the same token, the floor for net international reserves has been raised by $1.7 billion for all the test dates in the year 2001.

Regarding banking, an additional structural benchmark has been introduced calling for a new regulation conforming to EU standards, that defines direct and indirect ownership for the purpose of limiting connected lending. This new regulation should be in place by the end of February 2001.

The resolution of the banks taken over by the authorities is on schedule. And the authorities have clarified the nature and scope of the guarantee for depositors and other creditors of Turkish bank.

The Banking Regulatory and Supervisory Agency (BRSA) is also working on a new regulation for internal risk management and adjustment of capital adequacy requirements to reflect market risks. The enactment of this new regulation, which is a structural benchmark, was scheduled for the end of January 2001. Due do the heavy workload and complexity of the issues involved, there is a short delay. The BRSA remains committed to act expeditiously. The adoption of this regulation is on the agenda of the BRSA Board's meeting on February 5, and we will keep the Board informed.

The government has decided to transfer to the Privatization Agency not only the tobacco processing plants of the state monopoly TEKEL, but also the entire agency including its alcoholic beverage production facilities and its commercial assets. The restructuring of TEKEL will no longer be accomplished by decree, as was scheduled for the end of January, though this was not a structural condition under the program. The new approach is to enact it into law, which the government expects will be achieved by the end of February 2001. This will be a structural benchmark.

To further improve tax administration, the assignment of tax identification numbers (TINs) will be accelerated. Their use will be mandatory for a list of clearly defined transactions. The adoption of the necessary tax regulations by the end of September 2001 has been made a structural benchmark.

The enactment of the Electricity Market Law by the end of January 2001 is a structural performance criterion. A draft law was submitted to

Parliament on December 13, 2000. It has been discussed and approved by two parliamentary committees and was passed to the General Assembly on January 26, 2001. Since then, for reasons unrelated to this draft law, it has not been possible to gather the quorum necessary for parliamentary action. Meanwhile, action on this law remains one of Parliament's most urgent priorities.

It is expected that Parliament will soon resume its normal schedule. The Turkish authorities therefore request a waiver for the non-observance of this structural performance criterion, and propose that the enactment of this law by February 15, 2001 should be made a structural performance criterion.

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

The Fund's decision to augment the SBA and to provide resources under the SRF has been positively accepted and has provided some market stability, providing some relief for the Turkish economy. That being said however, the fluctuation in the amount of capital inflows and outflows and the volatility of short-term interest rates are worrisome, and medium-term interest rates remain high in anticipation of a future devaluation of the lira. Also, as seen in the fact that a growth slowdown has become evident, and the inflation rate remains above the rate of crawl, the performance of the macroeconomy is disappointing. Given the above evidence, we are far from proclaiming that the Turkish economy has regained its stability. Rather, given the apparent slowing down of the world economy, the downside risks are increasing, compared to the end of last year. The authorities and the staff seem to be in agreement that it is too early to judge how the program is affecting economic performance (paragraph 17). However, in order to adopt appropriate and effective measures when real risks loom large, it will be imperative to pay utmost attention to perceived risks.

The staff argues that the slowdown in growth is a fallout from the stagnation in credit provision, because of an increase in interest rates resulting from the crisis. This is an important argument. One must not underestimate the repercussions from the acute increase in credit extension last year. If an unwinding of last year's extension occurs, there will surely be companies and individuals that will suffer from a liquidity shortage, and interest rates will remain high. In addition to these domestic factors, the fact that exports will not grow as anticipated given the inevitable slowdown in the world economy, isn't there the risk that growth will be lower than was projected at the end of last year? If that were the case, what effects would it have on the fiscal and external balances? What are the policy measures left in the present macroeconomic framework? We welcome the staff's view on these issues.

It is foreseen that the NDA ceiling and the NIR floor will be met with comfortable margins, because of the net capital inflows since the outset of the augmented program. Given this situation, it has been suggested that the NDA ceiling be lowered and the NIR floor raised, to heighten the predictability of monetary policy. We see this as an appropriate signal for containing inflation. However, taking into consideration the risk of diminished confidence in macroeconomic policy, if these target should be missed, necessitating a re-loosening, perhaps it may be more prudent to create a wider path in monetary policy.

On the issue of privatization, we welcome the fact that many investors are showing interest in Turk Telecom, Turkish Airlines, and BOT projects in the energy sector. We also welcome the fact that concerning Turk Telecom, the government intends to submit to parliament a bill to remove uncertainty created by the pending court cases challenging the legality of the strong management rights assigned to the strategic investor. This, we feel, would have a positive effect on its selling price.

On restructuring of the banking sector, we welcome clarification of the scope of deposits and credits being guaranteed, as well as administrative arrangements for claims being set up. Guarantee is merely a measure used in emergency situations, and therefore it is desirable to minimize the cost associated with them. In this vein, we feel that the protocol calling for SDIF to employ least cost resolution methods to minimize the cost to the government, and to try to borrow from the market before turning to CBT so as to limit credit from the CBT, is indeed appropriate. Also, we think that necessary consideration has been given to the effects this operation may have on the conduct of monetary policy, in that, when SDIF borrows from the CBT, the CBT will absorb the funds so that it does not infringe on the NDA ceiling. We commend the authorities' efforts to compile such a framework in a short period of time.

On the banks that have been seized by the SDIF, it is encouraging to see that disposal is taking place as scheduled, in accordance with the interest being shown by investors. Announcing the deadline of the transition bank disposal also shows the strong determination of the authorities on the early resolution of this issue. The remaining task is to introduce a workable framework for expeditious collection of bad assets, and we look forward to seeing the details by the next review. We would also like to commend the fact that the work on strengthening of prudential regulation on banks is being made by the BRSA.

With these remarks, we support the completion of the fifth review of the Stand-By Arrangement, as well as the request for the waiver for the non-observance of the structural performance criterion relating to the electricity market law. The proposal to move its target date to February 15, as presented in Mr. Kieken's and Mr. Çakir's statement is well understood, given the recent unexpected incident.

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

Turkey has made considerable progress since the approval of the augmentation of access under the current program last December. Following a crisis that has seriously shaken confidence in the Turkish economy, calm returned to the markets with the provision of substantial support by the international financial community, and the initial crisis-attenuation measures taken by the authorities. However, although the financial markets are relatively calm at present, considerable risks to the economic outlook remain. The task facing the authorities at this time is to ensure that a solid basis for sustainable growth in a low inflation environment is put in place through the swift implementation of all measures envisaged under the current program.

Following the markets' test of the authorities' commitment to the exchange rate system, one key barometer of market sentiment in Turkey will remain the level of reserves for some time to come. We are therefore somewhat encouraged by the increase of $4.5 billion in foreign exchange reserves that took place during the course of January. Nevertheless, the developments underlying this increase leave little room for comfort. As the staff note in the paper, about half of the increase can be attributed to borrowing by state entities, including a $1 billion syndicated loan, and the first tranche of the World Bank's FSAL. The other half of the increase is primarily very short-term borrowing by Turkish banks. It is therefore clear that although reserves have increased, there has yet to be a meaningful return of foreign and domestic investors to the Turkish market. Furthermore, given the very short maturities of much of the borrowing underlying this increase in reserves, the improvement witnessed could be reversed relatively quickly unless there is a significant further increase in market confidence.

Restoring confidence is dependent on two important developments; namely, the trajectory of Net Domestic Assets under the monetary program, and the implementation of the agreed structural reforms in the financial sector. With respect to the former, we are very encouraged by the authorities' ability to over-perform the already ambitious targets agreed last December. The tightening of the performance criteria related to monetary policy under this review should send a strong signal to market participants of the urgency and seriousness with which the Turkish authorities are working towards restoring a solid foundation for the exchange rate peg, thereby providing the basis of a higher degree of confidence.

Turning to the financial sector, addressing the weaknesses that became apparent during the crisis is understandably complex, but no less urgent than any other measure envisaged under the program. The program envisages a series of actions to address these weaknesses, including policies to deal with the intervened banks. The investor interest in banks that have been taken over is encouraging, and we look forward to the use of a “fast-track” approach in the sale of these banks.

To properly address the weaknesses in the Turkish banking sector, the authorities are paying due attention to supervision and prudential regulations. Against the background of the recent crisis, the emphasis placed on the foreign exchange exposure of the commercial banks is appropriate. We are particularly concerned about the loopholes that may allow banks to circumvent the foreign exchange exposure regulations. We would also emphasize the importance of introducing regulation on the definition of connected lending. Indeed, tackling connected lending is a pre-requisite for improving the credit quality of the banking system’s outstanding loans. Looking ahead, however, measures to reduce connected lending should be accompanied by a close review of the regulatory and enforcement environment covering credit risk. As banks reduce lending to familiar clients, they would expand lending to less familiar clients, and a closer review of the credit risk will therefore likely be needed.

With these brief remarks, we support the proposed decisions and wish the authorities success in the period ahead.

Mr. Lushin and Ms. Vtyurina submitted the following statement:

The situation in Turkey seems to have improved and the danger of a full-blown crisis has subsided. The market sentiment appears to be generally positive while the participants are closely watching the developments under the IMF-supported program. The authorities have maintained the right pace of the reforms and the adherence to the program macroeconomic objectives. Nonetheless, in addition to the continuing domestic political and economic uncertainties, the growing pessimism about the developments in the world economy at large may dampen down the country’s economic prospects.

We are glad to see that so far the performance under the program has been satisfactory. Given the short period between the reviews it is difficult to make any definite conclusions about its effect on the markets. We would rather highlight a few developments that could add to the understanding of the market’s sentiment and expectations from the country.

Turkey’s return to the international bond market for the first time since its financial crisis, has been a welcome one. Albeit of a small amount, the issue has been fully subscribed to and this could signal good prospects for the country’s potential to borrow in future. In addition, major credit rating agencies have continued to maintain positive and stable outlooks on the sovereign.

The resolution of the banks taken over as well as of the state banks has been proceeding on schedule. This, being closely watched by the markets, produced a strong interest to acquire 4 of the 8 SDIF banks. The reform of the 4 state banks is also proceeding as planned, however, the recent attempt by the Virtue party to block this restructuring has produced some negative sentiment. The authorities should firmly pursue their banking reform strategy.

The issuance of the regulation on the definition of connected lending is being regarded as one of the major actions under the program. The fact that it is expected to closely comply with the EU standards adds credit to the initiative. It is also imperative that there is no further delay in introducing this measure. Regarding foreign exchange exposure, it is of utmost importance to ensure that the newly created working group is able to assess fully the risk involved in forward exchange contracts with connected parties. In order to limit this risk, the group must give its recommendations on introducing new monitoring procedures in the shortest possible time.

Turkey's attempt to find a strategic buyer of the 33.5 percent stake in Turk Telecom, besides the legal challenges, may be hampered by weak potential demand, which supports the staff apprehension about the possibility of lower privatization revenues. Indeed, the global economic weakening and the worrisome financial position of the world telecom sector are likely to complicate the effort. Also the sentiment of market participants appears to be mixed, with some seeing this privatization as being an important element of the program, while others perceive privatization in banking and energy sectors to be more critical to the success of the economy. If the latter holds true, from the revenue point of view it would seem more logical to wait till the international telecom market regains some of its strength and when the auction is able to generate more cash. Would the staff consider moving the auction deadline? We would welcome the staff views on the developments and prospects in this area of the program.

Finally, as does the staff, we see the situation to remain very fragile and risks to be significant. The higher than expected capital inflows are welcome, however, their short maturity is something to be watchful of. The high interest rates will continue to exert pressure on fiscal accounts and suppress economic growth. The exchange rate strategy is still to be tested, and for all that economic policies must remain on track.

We support the completion of the review and the request for a waiver.

Mr. Faini submitted the following statement:

Recent Developments

The approval of the SRF arrangement and the implementation of a tight monetary policy have succeeded, at least for the time being, in restoring financial stability. The authorities have also taken many useful steps to strengthen investors' confidence. These measures are well described in the informative preliminary statement of Mr. Kiekens and Mr. Çakir . We welcome in particular the cuts in discretionary fiscal spending, the clarification of how the guarantee for depositors and creditors will work, and the substantive progress with the resolution of problem banks.

The international environment has also become more benign. Notwithstanding the fear of a global slowdown, the Turkish economy should benefit from the continuing strength of the European economies, the weakening of the dollar, and, possibly, a more moderate evolution of oil prices.

The situation however remains fragile

Markets do not yet seem to be convinced of the strength of the exchange rate commitment. The staff is right in pointing out that the expectations of an imminent devaluation have subsided. However, the expectations of devaluation over the next few months have not abated. The yield curve has steepened sharply, compared to October, with rising yields over the next three months indicating that investors expect a currency depreciation well ahead of the scheduled date, July 2001, for the introduction of greater exchange rate flexibility.

The anticipation of a devaluation could feed into inflationary expectations. Under these circumstances, the inflation objective for 2001 is at considerable risk, even more so if we consider that the surge in inflation in the last two months of 2000 will carry over to 2001. Higher inflation together with a broadly predetermined path for the exchange rate will add to the real appreciation, risking to further undermine investors' confidence in the present exchange rate regime.

The macroeconomic outlook for 2001 is subject to many uncertainties. The staff project growth at 3.7 percent. Fiscal retrenchment may however take a toll on output. More crucially, the rapid expansion of private sector credit, which played a crucial role in fueling domestic demand in 2000, may come to an abrupt end in response to persistently high interest rates and growing exposures of the financial sector.

Investors' confidence has strengthened but is still shaky. It is true that capital inflows toward Turkey resumed during January. However, as noted in the staff report, much of the renewed inflows originated in borrowing by state entities. This could indicate that the recent improvements in the capital account have more to do with moral suasion exerted on state entities than with the restoration of private investors' confidence. The staff views on this issue would be welcome.

Policy Challenges

To preserve the hard-achieved gains and make them permanent, the Turkish authorities will need to pursue with determination their strategy of stabilization and reform.

First, they will need to ensure that monetary, fiscal, and banking sector policies remain compatible with the exchange rate regime to minimize the risk of a new currency crisis. We welcome in this respect the decision to remove the slack under the existing NDA ceiling and the Central Bank commitment to provide, if needed, the required liquidity to implement the guarantee to depositors and creditors. However, we remain concerned about the ability of the Central Bank to rapidly re-absorb this liquidity. Any injection of liquidity into the system should be accompanied by prompt actions – prompter than in the past (to intervene in the case of troubled banks. The staff comments on the steps taken to prevent a repetition of the events that led to the November crisis would be welcome.

Second, fiscal policy will need to remain on track and respond flexibly, if needed, to unexpected developments. The authorities should be praised for strengthening their commitment to fiscal consolidation. The increase of the primary surplus to 5.7 percent of GDP is, in our view, quite appropriate. However, substantive vulnerabilities remain. In particular, public sector borrowing remains very large, more than 10 percent of GDP, highlighting the continuing large borrowing needs of the government, despite the ongoing fiscal consolidation. Moreover, the fiscal outlook remains vulnerable to a slowdown in growth, the persistence of high interest rates (incidentally, why do the staff project for 2001 lower net interest payments than in the original program?), the cost of bank restructuring, not to mention the Damocles' sword of the blanket guarantee to bank depositors and creditors.

Third, the authorities need to ensure a smooth transition to the new exchange rate regime. The enactment of the new Central Bank law is envisaged for end-April. We would have preferred an earlier date, in light of the persistent concerns about the medium-term inflationary outlook. It is therefore essential that the April deadline be met without any delay.

Information on the status of the parliamentary debate on the Central Bank Law would be quite welcome.

Fourth, financial sector supervision must be further strengthened. We appreciate the efforts by the BRSA in this field and understand the need to adequately consult banks before issuing new regulations on connected lending. We are concerned however that the new environment, where the expectation of a significant devaluation over the next three months comes on the heels of a blanket guarantee to depositors and creditors, may exacerbate moral hazard problems in the financial sector. In the simplest case, bank creditors will have little incentive to evaluate whether their foreign currency-denominated loans are used by the bank to finance valid investment projects that can generate an adequate flow of foreign exchange. In addition, the provision of unlimited liability for the owners of financial institutions may interact in a somewhat perverse manner with the guarantee. Suppose for instance that the rule on unlimited liability means that banks are responsible for the behavior of their own private asset management units. Financial troubles in such units would then spillover to the banks themselves and could therefore in the end lead to the guarantee being called in. Could the staff clarify these matters?

Fifth, the privatization process must proceed as planned. We understand that the government has issued an administrative decree allowing the transfer of strong management rights to minority shareholders. To fend off legal challenges to the use of a decree to regulate such matters, the government intends now to submit a law to Parliament. Could the staff confirm that the administrative decree does not provide for any veto power by the government or its representatives on the board of Turk Telecom after privatization? Could the staff also confirm that the law to be submitted to Parliament will not modify the provisions of the administrative decree? Finally, can we confidently expect that the law will be enacted in advance of the issue of the final tender documents for the Turk Telecom privatization scheduled for the end of March (a structural performance criterion)?

To sum up, we agree with the staff that the risks ahead are significant. The Turkish authorities should be praised for their determination in implementing, over a relatively short period of time, many bold measures. They must however maintain the policy momentum and fully implement the agreed program. Failure to do so could shake investors' confidence and force a disorderly exit from the exchange rate regime, with devastating implications for inflation, financial stability, and, given the public guarantee to bank creditors, also for the budget. We wish the authorities full success in their endeavors.

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

We would like to commend the Turkish authorities for their decisive actions in implementing strong measures to face the recent financial turbulence, and for the firm commitment they have shown to the program objectives. We are pleased to note that the financial markets have reacted favorably to the strengthening of the Turkish stabilization program supported by the Fund's SRF. This has been indicated by a recovery in international reserves, a decline in interest rates, and a narrowing of the Turkish eurobond's spreads. The resolute decision by the Fund to expand its financial support to Turkey seems to have been decisive in helping to begin restoring market confidence. Once the financial turbulence is over, it is important not to lose sight of the primary objective of the program –namely, macroeconomic stabilization to break down permanently the inflationary process. Overcoming the financial turmoil can be seen only as one of the obstacles the authorities need to face. Policies would need to remain focused and consistent with the achievement of the broader disinflation objective.

The progress made in reducing the 12-month CPI inflation to 39 percent in 2000 from 69 percent in 1999 was considerable, even if not as drastic as programmed. December figures appear not to reflect yet the favorable effect of the monetary shock on prices, but a more rapid reduction in inflation may be expected throughout the first half of 2001, once the shock is effectively felt through the economy and appropriate policies are implemented. The rapid acceleration of GDP growth observed before the crisis was basically fed by strong credit expansion. There may be a slowdown in economic activity in view of the magnitude of the monetary shock and this would drive inflation further into a downward trend.

In an economy like Turkey's, which experienced a long period of high inflation, the memory of the inflationary process cannot be suppressed at once. Though the stabilization program has now been implemented for more than a year, it could still be seen as being in the early stage of a long process. It is important for the authorities to persevere in the implementation of the appropriate mix of fiscal and monetary policies to achieve the inflation target, supported by structural measures to reduce rigidities, especially the degree of indexation of the economy, and by privatization to help bridge financing needs.

In our view, the relative evolution of prices of tradable and non-tradable goods is an important variable that needs to be followed closely in a stabilization program based on an exchange rate anchor. In the initial stage of the program, when there is an abundant inflow of capital and expansion of credit, there tends to be excess of demand and the prices of non-tradable goods accelerate fast in relation to tradeables, whose prices remain more closely anchored to the exchange rate. The difficulty then is to bring prices of non-tradeables to a path more consistent with the nominal anchor. The monetary shock that impacted the Turkish economy, to a certain extent, may help to contain pressures on the non-tradable goods sector and may force a faster convergence between those two groups of prices. Some deceleration of economic activity therefore seems to be inevitable for stabilization objectives to correct excesses usually observed in the early stage of a program as in the case of Turkey.

In the fiscal area, we concur that tax administration needs to be strengthened. But we are sensitive to the authorities' view that "a bolder approach in rolling out Tax Identification Numbers (TINs)" recommended by the staff may lead to capital outflows. If that were to occur, putting pressure on the foreign exchange market would be very detrimental under the current post-crisis circumstances when financial conditions are still unsettled. Hence, there seems to be a case for appropriate sequencing to achieve the desirable objectives.

We favor a rapid resolution of the banking problem, including the building up of an appropriate institutional framework to support the process. A healthy banking system is essential to preserve monetary discipline and the integrity of the stabilization program. We note that there have been important steps in this area as pointed out in the report. The resolution of 11 banks under SDIF's control seems to have proceeded smoothly without a significant loss of deposits or other liquidity problems, and further actions are scheduled for the coming months.

Moving ahead with privatization is important to help meeting short-term fiscal financing needs and for improving economic efficiency over the medium term. The interest expressed by potential investors in the privatization of Turk Telecom and Turkish Airlines is encouraging. The government's intention to submit to parliament a law allowing the transfer of management rights to a minority shareholder would help to increase investor interest in the privatization of telecommunications. We also welcome the government's decision to transfer the tobacco state monopoly to the Privatization Authority. The restructuring of the electricity company into separate generation, transmission and distribution companies is an important step as it will be the enactment of the electricity law. We agree, however, that the parliamentary process is not totally controllable and delays can occur. But it seems that the small delay that is likely to occur in enacting such law would have no practical implications.

We support the proposed decision and the waiver requested by the Turkish authorities.

Mr. Le Fort submitted the following statement:

The additional information that has become available since the last review of Turkey's program a few weeks ago is limited and many important questions regarding the evolution of macroeconomic conditions remain to be defined. The staff report, and Messrs. Kiekens's and Cakir's preliminary statement provide valuable information on the advances in implementing the structural reform in the financial system, the cuts of discretionary fiscal spending, the strict fulfillment of the NDA target, and in general that the program remains firmly on track. These outcomes are to be welcomed and the Turkish authorities should be commended for their commitment and resolve.

It is encouraging to see the rapid advances in solving the situation of the banks taken over by the Financial authority and the reform and privatization of the state-owned banks; we hope that the authorities could proceed expeditiously as planned in solving the problems of the financial system. The announced introduction of rules on capital adequacy is also to be commended, particularly considering the authorities' view of using higher capital requirements, given Turkey's volatile environment. We are encouraged by the progress in this area and urge the authorities to continue the implementation of regulation directed at reducing risk-taking by banks. It is particularly relevant to move ahead with the limitations to connected lending and guidelines on acceptable market risk.

The government guarantee that covers bank liabilities seems to be extremely wide, even covering off-balance sheet claims and deposit in foreign branches. The potential moral hazard in the banking system and the very large contingent liabilities faced by the public sector because of this blanket guarantee, are reasons to limit its use only for the period in which it is deemed to be indispensable. To have this blanket guarantee in place until the financial restructuring is completed seems excessive.

The predictability of monetary policy under crawling-peg type of arrangement is given by the peg rule itself, and ensured by the strict application of the convertibility rule expressed in the NDA target. Under this scheme, base money cannot be controlled, and there is no reason to attempt doing so. In this sense, I do not agree that adjusting the NDA and NIR targets will increase the predictability of monetary policy and agree with Mr. Yoshimura that the adjustments in the target increase the risk of a future erosion in confidence should the over performance be based in transitory elements. The staff comments on the origins and implications of this over performance would be welcome, in particular why they consider that under existing conditions the NDA reduction should be permanent.

The success in building confidence has been so far limited, market confidence has been restored only to some degree. Although some short-term capital inflows have helped the level of NIR to recover, and reduce interest rates, they remain high, revealing the perceptions of exchange risk for the Lira. Domestic interest rates have increased to levels clearly above relevant international market rates for Turkey. The spread for Turkish debt in international markets of 600/700 basis points does not justify domestic interest rates measured in U.S. dollar terms of around 40 to 50 percent. This is a signal that the expectations of currency realignment remain strong.

There has been a gain in confidence and relative calm in Financial Markets from the worst days in November-December, but the question that remains open is whether these gains will be sustained and will prove sufficient to support that macroeconomic framework on the basis of which the program was designed. The confidence gain, so far, seems not to be sufficient in the sense that domestic interest rates remain excessively high in real terms, and could have a severe negative impact in economic activity. I would appreciate to hear the staff comments on the recent evolution of real interest rates and their likely impact on domestic demand and economic activity during 2001.

There are significant risks for the financial system and for macroeconomic stability derived from the likely effect of the high interest rates on economic activity. The high rates and the contraction in activity could result in a deterioration in the quality of loans portfolios and weaken the financial sector. They could also result in a reduction in public sector revenue, higher domestic debt service and in general a deterioration in an already weak fiscal position. The large capital inflows, rapid expansion of activity, widening of the current account deficit and increasing inflationary pressures of last year are elements of the past. The policy stance needs to be defined on the basis of the road ahead, and although at this time the degree of the turn around is very difficult to define, it is very clear that it is happening. It will be important to measure the extension of the turn around and adjust the macroeconomic framework of the program accordingly.

This Chair supports the completion of the review and the request for the waiver on the non-observance of the structural benchmark relating to the electricity market law. We commend the authorities for their efforts, urge them to continue advancing in the reform program and wish them every success.

Mr. Mirakhor submitted the following statement:

We thank the staff for the concise report, and Mr. Kiekens and Mr. Çakir for their informative and articulate statement. The strengthening of policies initiated last December, along with the support of the international community, have helped restore a measure of calm and stability to the Turkish economy. This has manifested itself in higher-than-expected capital inflows, a gradual decline in interest rates, and a build-up of the central bank's reserves.

We welcome the news that "policy actions in all critical areas" have generally been in line with program expectations, and that almost all actions envisaged in the December Letter of Intent have been taken. We, therefore, join Messrs. Portugal and Mori, as well as other Directors, in commending the authorities for the strength of their resolve to meet the challenges emanating from the recent financial turmoil and their strong commitment to the program objectives.

The Turkish economy is not yet out of the woods. While policy credibility is improving as implementation of the strengthened program proceeds, the situation remains fragile, particularly as there are disturbing signs of a possible slowing of growth—attributable to the dramatic tightening of macroeconomic policies, as well as to the apparent slowdown of the world economy, as Mr. Yoshimura and Mr. Toyama suggest. The progress in reducing inflation has been good, but it remains worryingly high in relation to the rate of crawl. This highlights the crucial importance of keeping a firm grip over macroeconomic policies. It will be critically important to maintain the focus of attention on stabilization and, therefore, keep fiscal and monetary policies firmly on track, including taking bolder steps to strengthen tax administration as the financial situation improves. Efforts should also be exerted to ensure that the privatization program is implemented on schedule.

The envisaged actions in the area of banking are comprehensive and well thought out. Their implementation will be carefully watched by markets as a test of the authorities' determination to forcefully address an area of significant vulnerability. We support the thrust of the contemplated measures and are pleased to note that the staff gives high marks to the leadership of the BRSA. In light of recent developments, we urge BRSA and CBT to expedite the work on improving supervisory risk assessment and early warning systems, especially as it relates to the risks associated with counterpart exposures in foreign exchange forward contracts. We support the new deadline on the issuance of regulations on the definition of connected lending. On nonperforming loans, we look forward to expeditious enactment of legislation that would give the SDIF enhanced recovery powers and note that further work toward developing an efficient asset recovery process is envisaged in the context of the next review. We support the proposed decision and the waiver requested by the authorities.

The staff representative from the European I Department, providing additional information on program conditionality that had appeared after the staff report had been issued, noted that the NDA and the NIR performance criteria for end-January 2001 had been met by a wide margin. The NDA level had been in line with the projections in the staff report of minus TL 300 trillion, against a ceiling of TL 900 trillion. The NIR floor was also met by a wide margin of approximately \$2.3 billion. The Bank Supervision and Regulation Agency (BRSA) had also approved the regulation on banks' internal risk management and capital adequacy ratios a few days after the date specified under the relevant structural benchmark.

As Mr. Kiekens had pointed out, the electricity market law had not been approved in time as a result of the parliament's recess. The authorities had requested a waiver, proposing that the enactment of the law should become a structural performance criterion for mid-February 2001. The staff supported this request, taking into account the reasons for the short delay.

Regarding other non-conditionality related recent developments, the staff representative informed that the 12-month WPI inflation rate published in January 2001 was below the 30 percent threshold, standing at 28.3 percent. The CPI rate had fallen to 35.9 percent. However, the seasonally adjusted monthly inflation rates were still above the rate of crawl, with a 1.8 percent WPI rate, and a 2.1 percent CPI rate against a rate of crawl of 0.9 percent. In the last two days of January, the Central Bank had lost approximately $800 million in foreign exchange reserves. The subsequent increase in the first days of February suggested that this movement was related to a month-end balance sheet effect. However, there had been some additional pressure in the foreign exchange market in recent days, with losses of nearly $200 million, and interest rates on the overnight market practically reaching the 70 percent level.

On monetary policy, the staff representative observed that the removal of the slack under the previous NDA ceiling had been the only relatively important change in the monetary policy framework since the last review of the program in December 2000. While Mr. Le Fort was right in saying that base money could not be controlled under a pegged exchange rate regime, this was only the case if the exchange commitment was fully credible, as this would leave virtually no scope for the control of interest rates and base money through monetary policy. However, in a situation where the exchange rate commitment was not fully credible, capital movements would not be perfectly elastic, and, therefore, interest rates could be set internally rather than by the foreign exchange market. This possibility was particularly critical when the exchange rate commitment was being challenged. While confidence had risen in the last months, in the event of a speculative attack, the behavior of NDA in the early stages of a crisis of confidence would be crucial. A large slack under the NDA ceiling would allow the authorities to inject liquidity and avoid the increases in interest rates that would be needed to stem the speculative attack. The removal of the slack reduced uncertainty over the authorities' reaction in the event of a speculative attack, thereby increasing the predictability of monetary policy. Furthermore, the fact that the prior NDA ceiling had been established in early December 2000—a moment of extreme uncertainty—made it likely that a subsequent revision of the ceiling might be required. Removing the slack under the NDA ceiling implied that foreign exchange reserves should remain at current levels, which appeared appropriate.

On the related issue raised by Mr. Faini regarding the control of liquidity, the staff representative assured the Board that the cooperation between the Central Bank, the BRSA, and the treasury had been improved to ensure that the resolution of banks that had failed to meet their obligations would not pose additional pressures on liquidity. While an initial lack of coordination had caused some confusion over the respective responsibilities of the three institutions, a protocol had been agreed that envisaged a rolling facility for the BRSA to draw upon in order to complete the banks' recapitalization. The rolling facility regulated the access of the BRSA to Central Bank credit.

In response to Mr. Faini's question on the progress made with the new Central Bank legislation, the staff representative informed that the law had not yet been sent to Parliament, as the legislative proposal was currently being reviewed by the Prime Minister's office. There were no major disagreements with the Central Bank on the contents of the proposal, although the number of articles in the law would be reduced to facilitate its passage, given that Parliament had to approve each article individually.

On Mr. Yoshimura's question regarding the implications for the fiscal account of the uncertainties surrounding the economic growth forecast, the staff representative acknowledged that there were downside risks, given the high current level of interest rates, the uncertainty over the exchange rate regime, and the interest rate outlook. While those uncertainties made it likely that the growth rate would be lower than projected under the program, it was difficult to assess the extent of the shortfall, given the limited information currently available. The data on GDP growth in the last quarter of 2000 were not yet available. The available data on early indicators of economic activity were somewhat contradictory, with weak automobile production but a strong fiscal surplus, and a good export performance. It was not possible to analyze the sources of the fiscal surplus, as the breakdown of revenues and expenses was not yet available. It was also not possible, at this stage, to conclude whether the data published by the Exporters Association for the month of January 2001 indicated the substitution of international demand for domestic demand. It would not be possible to assess the situation until the following review in March 2001. Regardless of the actual extent of the slowdown of the economy, the staff had estimated in the past that a reduction of one percentage point in economic growth would result in a fiscal loss of 0.2 percentage points of GDP. The impact would likely be even higher in 2001, taking into account that demand for highly taxed consumer durables was decelerating rapidly. Therefore, the fiscal loss could amount to 0.3 or 0.35 percent of GDP for every percentage point of slower growth. The staff maintained the view expressed in the December 2000 staff report that the most appropriate reaction to a fiscal loss caused by a slowdown would be to allow the automatic stabilizers to operate, provided that the evolution of inflation and of the external accounts remained favorable.

Regarding Mr. Faini's question on why the staff's projection for 2001 interest payments was lower than in the original program, the staff representative explained that the government would in 2001, benefit from the issuance of zero coupon bond securities in 2000, which had been issued at a lower rate than projected in the program. Hence, there would be a lag between the recent rise in market interest rates and the increase in the government's interest payments, which would not be felt until 2002.

On the privatization of Turk Telekom, the staff representative observed that the weak international conditions in the industry might delay the sale even if the authorities implemented the actions required in the program. This would not in itself have major consequences for the achievement of the fiscal revenue targets. However, the confluence of this negative shock of limited intensity with other shocks such as the higher interest rates, slower economic growth, and possibly additional costs associated with strengthening the banking sector would provide a more worrying outlook. One positive aspect was the decline in international interest rates, which would allow the government to issue more bonds than projected. The program conditionality did not specify a date for the Turk Telekom sale. A commitment date had only been specified for the preliminary step of issuing the invitations to bid, thereby allowing the authorities some flexibility to fix the date of the auction. Hence, a delay in the auction would not affect the program as such.

On Mr. Faini's questions on the telecommunications sector, the staff representative clarified that the administrative decree governing the privatization process did not provide the authorities with veto powers in the company's Executive Board. Decisions would be taken by simple majority in the Board which would be controlled by strategic investors. The law that would be sent to Parliament would not withdraw the management rights granted to strategic investors. The courts had challenged the approval of changes in the regulation through a decree, but not the content of the decree itself. The new law would likely be enacted by March 2001.

Regarding Mr. Faini's questions on the banking sector, the staff representative considered that the risk of spillovers of problems in the private asset management units of banks to the banks themselves as a result of the unlimited liability principle was negligible. The guarantee covered the liabilities of the banks, not those of the owners of the banks. A more important issue would be whether the problems in a parent company could spill over to the bank. Those concerns pointed toward the main problem in the banking sector, the risk that ownership of banks by industrial conglomerates could lead to interference from the parent companies with the lending activities of banks. It would be advisable to investigate the implications of unlimited liability in future missions. The legal aspects of the problem would likely be covered in the following mission.

Mr. Faini stressed that risks to the inflation and exchange rate outlook constituted the main threats to the stabilization program. The failure of inflation to fall in line with the 2000 program projections was particularly worrying, as that had led to a slightly higher than anticipated real appreciation of the lira. As the staff representative had noted, not only had inflation been high on average, but it had also failed to follow a declining path, while further increases would likely occur in the first months of 2001. Perhaps the staff could comment on the concerns over the potential exchange rate overvaluation raised by the latest data on inflation.

The staff representative from the European I Department acknowledged that the staff's expectations—conveyed to the Board in the December 2000 discussion—that the deceleration of domestic demand and that associated easing of pressure on output capacity would facilitate the decline in inflation, had not been confirmed by the data released in January 2001. However, it was hoped that the disappointing data, even if expected by the markets, would be followed by more favorable data in the following months as the effects of the deceleration of domestic demand started to be felt in the economy.

Mr. Kiekens clarified, with regard to information provided in his preliminary statement on the evolution of international reserves, that it could be analyzed through two alternative methodologies that could produce different conclusions. The first approach would be to use a constant exchange rate and to monitor the evolution of gross reserves without taking into account the fluctuations in the different components. The second approach would be to report the market valuation of the amount of foreign reserves, which would capture both the changes in volume and in exchange rates. The first approach had been used in the preliminary statement, based on the data that had been provided by the authorities. However, the fact that the approach taken by the authorities had changed a few months prior to the discussion—without making the necessary recalculations on past data to allow for the correct interpretation of the series of changes in foreign reserves—meant that the series that had been presented to the Board was not internally consistent. While the staff's data for the period since the outset of the crisis was also not internally consistent, the estimated loss of reserves as a result of the crisis was in the order of $6.5 billion in volume terms. It had also been assumed that this loss would have been reversed by the time of the Board discussion, taking into account the recent purchase under the IMF-supported program. However, based on the market valuation, the amount of gross foreign reserves, which had been $24.4 billion at the start of the crisis, had risen to the current level of $25.8 billion, revealing a gain of $1.4 billion. This reflected the appreciation of other components of reserves vis-à-vis the dollar.

Mr. Abbott made the following statement:

Turkey's strengthened adjustment program has gotten off to an encouraging start, but the authorities' margin for error remains extremely small. The economy has become even more vulnerable to shifts in market sentiment since the crisis, as confidence remains very fragile.

Restoring confidence in the economy will require rigorous implementation of the program and greater transparency. In particular, clarifying policy measures (such as plans for bank resolution) and disclosing available information (such as the foreign exchange position of banks) will help reduce the high level of perceived uncertainty in Turkey. Meanwhile, resolute action is necessary to manage the significant risks going forward. This will entail not just meeting, but over-performing on certain program goals, as well as planning carefully for contingencies.

Monetary Policy and Exchange Rate Policy

The conduct of monetary policy over the past month has successfully brought Net Domestic Assets down well below the program ceiling established in December and a good way back to the pre-crisis level. Lowering program ceilings to lock in this over-performance is a positive step that will increase the transparency and predictability of monetary policy going forward.

Even though monetary aggregates have been brought back into line with program requirements, persistently high yields on Turkish T-bill clearly reflect demand for a high premium to compensate for exchange rate risk. This is a clear indication of market concerns regarding the current exchange rate mechanism as well as uncertainty about the evolution of the exchange rate mechanism as Turkey begins its transition away from the crawling peg.

These worries will be exacerbated by further real appreciation resulting from a continued overshoot of inflation targets. A significant added source of vulnerability is the very short-term nature of foreign exchange inflows in January.

Interest Rates

Rates in the overnight money market have come down to a comfortable level, but yields for domestic T-bills remain uncomfortably high, raising risks to the fiscal balance given the continued large public sector borrowing requirement.

While the recent placement of a euro-denominated bond at a spread of 390 basis points over the benchmark is somewhat encouraging, we remain concerned about the market's response to the relatively large amount of international borrowing the government is planning for this year. The close attention of market participants to any slippage in the privatization agenda, which might necessitate further external borrowing, is an indication of the tight situation.

Structural Reform

To rebuild confidence, Turkey needs to implement structural reform measures according to the substance and timing in the program. Turkey can ill afford further delays, even if there are good explanations for some of those that have occurred.

We can support the requested waiver for the enactment of the electricity markets law, but we fully expect that such missed deadlines will become very much the exception in implementing the program going forward.

Privatization

Despite an early start to the tender for the Turk Telekom privatization, there is a significant danger of disappointment stemming from a variety of factors. These include weakness in the European telecoms sector, questions over the transfer of strong managerial rights along with a minority stake in the firm, and the threat of legal challenges to the privatization.

Given the significance of this privatization, both as a policy signal and as a source of privatization receipts, these potential problems create a risk to the entire program which can only be reduced through determined adherence to the tender schedule and terms, as well as continued political support.

Reform of Tax Administration

Concerted efforts to improve tax administration are becoming increasingly important to the program's success, as the risks to fiscal balance may grow due to high T-bill rates and uncertain growth prospects. In an economy with such large fiscal imbalances, and where as much as 40 percent of economic activity may go unrecorded, the Turkish authorities have a long way to go in this area.

Setting a timetable for rolling out tax identification numbers and requiring their use for some banking transactions are notable developments, but we would urge the authorities to consider advancing the process as much as is prudent.

Banking Sector

We are encouraged by recent progress in the resolution of the intervened banks, since maintaining the schedule for their full resolution is critical for market confidence. However, we are concerned by the decision to merge the operations (and not just the balance sheets) of the banks that did not attract interest into one "transition bank", thereby delaying final resolution.

This naturally will raise comparisons with Indonesia's prolonged experience of merging four banks into Bank Mandiri. Given the decision to pursue this strategy, it is important that operational restructuring take place this month and final resolution be completed at end-September as planned, as delays will only increase the total cost of the resolutions.

And while it is prudent to be sensitive to the fiscal/debt management implications of bank clean-ups, too much sensitivity on this dimension is likely to translate into a disposition toward forbearance. Getting the balance right is going to be tricky.

The banking actions agreed in the program are limited, but they are detailed and concrete, and the authorities will have to press ahead diligently with the agreed timetables. It should be noted, however, that even if the specific actions in the program are completed in full and on time, they may not solve the problems of Turkey's banking sector, which will require a concerted effort to implement strengthened regulations addressing the country's pervasive connected lending problem. We also continue to be concerned about the open foreign exchange position of the banking system, including uncertainty over the quality of the hedging.

Mr. Pickford made the following statement:

I welcome the progress to date, in particular, in implementing the required reform measures. Against that background, I agree to the request for a waiver, assuming that the authorities will complete the outstanding tasks soon, and I support the completion of the fifth review. However, as Mr. Abbott and others have stressed, there are still significant risks that leave limited room for maneuver in the implementation of the program. The financial sector remains fragile, and the macroeconomic environment contains a number of risks. In particular, as other Directors have pointed out, the fact that T-bill rates are still above pre-crisis levels carries significant risks for the fiscal balance. The persistent high inflation above the rate of crawl for the exchange rate also carries risks. In the light of these risks, the authorities need to continue to implement the remaining program requirements fully and in a timely manner. Even tougher reform efforts than originally envisaged will be required in the likely event of weaker-than-anticipated growth. However, political uncertainty might threaten the program's implementation. Perhaps the staff could comment on the likely effects of a potential governmental decision to ban the Virtue Party. I would like to comment on four issues in particular, which are macroeconomic policy, banking sector reform, private sector involvement, and privatization.

First, as the staff representative has pointed out, the crisis has caused the economy to slow down, even if the extent of the slowdown is not yet clear. While the staff have not adjusted the fiscal outlook in the current review, it is likely to change in future reviews. The market seems to have adjusted expectations faster than the staff, with some of the estimates of growth for 2001 as low as 1.5 to 2 percent of GDP. One possible impact of lower than expected growth could be that consumer loans given in the last two months may become non-performing, which would clearly have negative implications for the banking sector. These risks call for caution in assessing the situation. As the staff representative and other Directors have pointed out, inflation is still significantly above the rate of crawl, which might lead to increased pressure on the exchange rate. In this regard, the sooner the financial sector reforms are tackled, the better. The authorities need to keep working on the monetary regime that will be needed after the rigid crawl is ended.

Turning to the banking sector, the continued fragility of the sector calls for the provision of greater detail on balance sheet risks, in particular liquidity and exchange rate risks, in future reviews. I would be grateful if the staff representative could give us an update on the stress tests on interest rate risk performed during the MAE mission. While the banking reform measures, such as the introduction of a guarantee, have been successful, the process to remove the guarantee needs to be clarified to avoid market confusion. The development of a system with effective risk management procedures is also vital. It is encouraging to see that the authorities recognize this as a priority.

This ties in with the need for banks to move away from their traditional role of arbitraging in public sector paper toward a pattern of more normal banking activity, focused on providing loans to the private sector. Banks will have to develop more sophisticated techniques for credit analysis, and that will take some time to implement. I would be grateful if the staff could provide further detail on the status of the transition banks after the non-performing loans have been transferred to the asset management function. Does the government intend to retain state control over the banks or will they be offered for sale at a later stage?

Private sector involvement appears to be working, although there are some signs that it might be weakening. Rollover rates have been generally high at close to a hundred percent. However, significant outflows of capital have continued, and capital inflows have been extremely short-term, largely overnight. In this situation, cautious and careful monitoring will be needed on a regular basis. Progress against a benchmark should be measured in each review to monitor the maintenance of consistently high rollover rates. The rollover risk is extremely high, with basic calculations showing that the amount of short-term debt falling due this year is above $50 billion, and over half of this debt is expected to be financed through bank and other short-term rollovers.

Finally, we have some concerns about the delays in the privatization process. As the staff representative has pointed out, there is a risk that revenue expectations from privatization will not be met, given the limited interest among international bidders. If that is the case, policy adjustments will be needed elsewhere to offset the shortfall in revenues, as an increase in external financing needs would not be acceptable.

To conclude, we think that, while progress to date has been sufficient, the risks remain substantial, especially taking into account the less favorable external environment. These risks increase the need for rapid progress on bank restructuring to make the system more resilient to future shocks and allow the economy to move toward a more flexible exchange rate regime.

Mr. Azoulay made the following statement:

I would like to thank the staff and management for their efforts to resolve Turkey's economic problems and for the preparation of this program review. The Fund's increased assistance has helped the authorities to restore confidence. The crisis has been alleviated, with foreign creditors keeping their credit lines open, and most rating agencies regaining their positive outlook on the country's credit worthiness despite the remaining uncertainties. However, as other Directors have pointed out, the situation is fragile, and the economy remains exposed to a possible financing shortfall.

The main risk to the program lies in the banking sector, which remains weak and vulnerable to adverse sentiment. An increase in the number of insolvent banks or a higher-than-expected cost of the ongoing bank restructuring process could undermine the progress made on the fiscal front in the year 2000. Financial markets usually react faster than the authorities, and they will continue to exploit any loopholes in the regulatory regime. In this context, will encourage banks to reduce their foreign exchange exposure. However, the possible rapid unwinding of this exposure could create a huge demand for domestic currency leading to another liquidity shortage, given the expectations of a large devaluation implied by current money market rates. Whether the initial restoration of confidence will be sustained, and whether the Fund-supported program can succeed will depend greatly on the authorities' ability to maintain their commitment to the implementation of reform in a forceful and timely manner.

As noted in the staff report, the authorities have implemented all the measures to which they had committed for this review in their Letter of Intent. The authorities' key challenge will be to continue their commitment to banking reforms and privatization while maintaining macroeconomic stability and strong prudential supervision. I endorse the staff's appraisal and I support the completion of the review. The main priorities continue to be a strengthening of the banking sector and of the fiscal balance. A speedy resolution of the intervened banks will be crucial. The authorities have decided that 10 of the 11 banks in trouble should be sold, and they will make a decision on the remaining bank in few months. We are interested in knowing why the authorities have not followed the same process they followed in the case of the banks that were initially put on the market. In addition, we regret delays in the implementation of other key measures, such as the enactment of regulations on quarterly consolidated reporting by banks to allow examination of their financial subsidiaries, and of regulations on internal risk management, which the staff has confirmed, have only recently been introduced. Given the risks associated with the short-term nature of most recent capital inflows, we are concerned about the enforcement of the regulation on the ceiling on banks' open foreign exchange exposures. We have learned that four banks are not in compliance with prudential regulations. We are also concerned about the accuracy and quality of data in this area.

On the fiscal front, it will be complicated for the government to pursue a prudent fiscal policy in a more negative environment. The government will have to resist public pressure to ease wage growth and fiscal consolidation, given the key role that they play in the anti-inflationary strategy. In the last Board discussion on Turkey, the staff confirmed that the fiscal sector analysis included the likely cost of the bank restructuring process of approximately $30 billion for the banks currently under the authorities' control. Estimates made by rating agencies indicate an even higher figure. In this connection, we believe the Fund and the authorities contemplate in their fiscal scenarios the possibility that more banks might become insolvent. We would also like to know if the staff has run stress tests analyzing the potential budgetary impact that could arise from the level of banks' problematic assets. The authorities should start seeking financing in March and April 2001, given the amount of debt that will need to be rolled over. In this context, we would welcome comments from the staff on the effects for the program of a lower-than-expected rollover rate of debt.

Finally, I would encourage the authorities to make less use of side letters, given the Fund's drive for greater transparency. Experience in other cases shows that, in this era of sophisticated financial markets, we can realistically assume that market participants may be able to divine the issues treated in such letters. I believe that a more forthcoming attitude toward disclosure could support investor confidence. A more forthcoming attitude would also encourage the kind of open and comprehensive discussion that best serves the Fund and the authorities' interests.

Mr. Siegenthaler made the following statement:

As other Directors have noted, the situation in Turkey remains fragile. If there were any substantial slippages under the program, this fragility would be easy to explain. However, the authorities have so far lived up to their policy commitment and the continuous lack of investor's confidence remains thus a bit of a puzzle. In our view, there are at least three possible explanations: The first one is that there are some factors affecting confidence, such as political instability, which are outside the reach of the program. This seems to be the most likely explanation. However, a second possibility is that the program does still not sufficiently address some crucial issues, like the problems in the banking sector. And finally, it is possible that investors lack information regarding the precise content of the program and envisaged policy measures. In this latter respect, we think that the new Letter of Intent fulfils just the minimal requirements in terms of information.

In any case, it seems very clear that just the slightest divergence from the program can have dire consequences. Today's developments on Turkish markets offer a case in point. Market indicators have fallen across the board, due to some doubts about the authorities' ability to implement crucial reform measures. Sticking thoroughly to the program is thus more imperative than ever.

The short time period that has elapsed since the last review makes an evaluation of the effects of the policy actions since December very difficult, especially in light of the scarcity of new data. Furthermore, adequate information is missing in crucial areas, such as the banking sector. It is therefore hard to say whether the crisis has indeed been averted or merely postponed.

Let me begin by commenting on some areas where we do have information:

A clearly very positive signal comes from monetary policy, where the authorities have managed to significantly overperform on the NDA targets. We also welcome the decision to tighten these targets in order to lock in the previous gains, since this could be a crucial factor in helping to restore market confidence.

Fiscal policy reforms revolve around the privatization of major state enterprises. Unfortunately, the respective preparations, especially in terms of passing legislation, have been interfered by political issues, thereby sending out unwelcome signals to investors. We recognize the strong commitment of the authorities reflected in their pushing forward an important - albeit politically very delicate - issue. Given that privatization receipts are the central component of financing in this year's budget, the authorities have no alternative but to press ahead. The privatization issue will continue to be the markets' key indicator for the governments' reform commitment.

Obviously, the persistence of interest rates at exceedingly high levels remains a great cause of concern. Such high levels are likely to dampen growth and the resulting slowdown in economic activity will put additional strains on the fiscal situation, both through lower revenues as well as through a rising debt burden. Again, the only viable way out of this vicious cycle is to forcefully implement all the program measures and thus bring down the interest rates.

Let me now comment on two areas where a sensible judgement of the progress under the program would have required a more thorough background, namely the health of the banking system and private sector involvement.

Regarding the banking system, information is clearly a very scarce good. On the future of the seriously and/or terminally ill banks, the staff has, to date, provided quite a bit of information. With regard to the so far considered "healthy" banks, however, we still have too little insights into potential dangers lingering on their horizon. I agree with Mr. Pickford that the staff will need to provide more information for future reviews. This is particularly true with regard to the credit risks associated with forward exchange contracts. Regarding the ailing banks, like others, we are uneasy about potential implications of the very far-reaching guarantee. While we recognize that this guarantee is of utmost importance for keeping money in the country, we still worry about the sustainability of such a set-up. We wonder when and to what extent the guarantee might, firstly, interfere with monetary policy targets and, secondly, become a fiscal strain. Like Mr. Le Fort, we would have preferred a more restrictive deadline for the guarantee. I would appreciate the staff's comments on this matter.

The reflux of capital—and specifically the high rollover rates achieved with foreign banks—has received much attention and praise. However, the success of this measure seems much less impressive in view of the high level of interest rates and the full government guarantee. Under such favorable conditions and with a comprehensive Fund-supported program in place, one would actually expect the bankers to step on each other's feet in Turkey. The fact that a sizeable capital outflow had to be registered during January and that most inflows have been of a short-term nature is thus all the more worrisome. Regarding PSI, it was our understanding based on the last Board discussion that a more in-depth analysis of the strategy followed in Turkey would be pursued for this review. We were thus disappointed to see that no such attempt has been undertaken. Without a careful analysis of the nature of the Turkish PSI, it is not possible to judge the success of the program in this respect. For the time being, I can only reiterate that we are sceptical as to whether the approach chosen in Turkey can actually be called PSI, as we understand it.

With these remarks we approve the waiver requested by the authorities and accept the completion of the fifth review of the SBA.

Mr. Wei made the following statement:

At the outset, let me thank the staff for the well-written and concise report, and Mr. Kiekens and Mr. Çakir for their very informative and helpful preliminary statement. I also thank the staff for the daily updates on Turkish interbank obligation rollovers.

As I said at the Board meeting on December 21, 2000, we are very glad to see a sense of calm has returned to the Turkish markets. Since the Board approved the SRF a month ago, it is encouraging to learn that the program is broadly on track, with many positive signs emerging, despite the prevailing risks. As we learn from Mr. Kiekens and Mr. Çakir, interest rates are now below pre-crisis levels, and reserves have fully recovered. Fiscal and monetary policies are being carried out strictly in line with the program. Therefore, we support the completion of the fifth review of the SBA and have no problem with approving the waiver of one performance criterion given the understandable reason put forward by Mr. Kiekens and Mr. Çakir.

Since, we broadly concur with the staff appraisal, we will focus our comments on two aspects which we think deserve our special attention: foreign exchange reserves, and the full guarantee of depositors and creditors.

The slowdown of economic activities after a market shock is understandable. However we agree with the staff that it is still early to revise downward the growth prediction figure for the whole year because it may send the market a negative signal about the economic outlook. It is very important to consolidate the hard-earned market calm into longer-term stability. The government's prompt action in seizing the opportunity of the improved market conditions in late January to launch an issue of three-year euro-denominated bonds is commendable. However, there are still concerns. Although the exchange market tension at the very end of January was partly caused by end-month adjustments in investment portfolios, we have to be cautious and to keep an eye on market developments and reserve structure. As pointed out in the staff report, half of the reserve increase over the past month is on banks' very short-term borrowings, and the other half includes foreign borrowing by state banks. These are not very stable or reliable foreign exchange resources and outflows can be triggered by any lack of confidence or other shocks.

On the banking reform front, we welcome the measures taken on four aspects elaborated by the staff and the recently introduced structural benchmark calling for a new regulation conforming to EU standards. The authorities' firm determination to resolve these banking sector issues is reassuring as seen in the February 20, 2001 deadline for revoking licenses of banks which have no investor interest and in the announcement of a time framework for closing the majority of these banks' branches. The restructuring of the banking sector is always a complicated task involving many aspects of the economy, such as high fiscal cost and monetary liquidity management. Therefore, its implementation needs continuous effort and special care. In this connection, we a question regarding full guarantees granted to banks' depositors and creditors. We understand these policy measure can be an effective method for restoring confidence in banks and stabilizing financial markets in the short term. However, I wonder whether this may put pressure on the budget? I would like to ask the estimated fiscal cost of guaranteeing full funding to the SDIF, and what impact it may have on the fiscal account. We also want to know how to ensure the NDA ceiling, given that the facility extended to SDIF may increase the money supply, and what mechanism is employed to encourage the SDIF to borrow from the market before turning to the CBT. The staff elaboration is most appreciated.

Before concluding, we would like to join Mr. Mirakhor, Mr. Faini and other Directors in commending the Turkish authorities for their determination to implement many bold policy measures. With these remarks, we wish the Turkish authorities every success.

Mr. Couillault made the following statement:

At the outset, let me say that we support the completion of the review and the request for a waiver on the non-observance of the structural benchmark relating to the electricity law. The Turkish authorities have taken decisive steps to calm down markets but the volatility of capital flows remains particularly high and Turkey is still on the brink of a new crisis. Strict adherence to the program is the only way to restore confidence permanently and dissipate the anticipations of devaluation.

Against this background I will only stress three points of particular importance.

First, markets' participants will scrutinize the restructuring of the banking sector closely. The banking system is inefficient, fragile, and oversized ; any loss of confidence will immediately have serious consequences on the peg. The design of the restructuring process as presented by the staff sounds sensible. However, given the uncertainties surrounding the level of bad loans or the quality of some hedging positions, I am wondering if the SDIF would be in a situation to absorb the consequences of an additional shock of confidence in the banking sector and I share Mr. Faini's concerns relating to the injection of liquidities which could be needed. The staff comments on the current financial situation of the banks seized by the SDIF would be appreciated and we will be looking forward to a more in-depth analysis of the vulnerabilities of the banking sector.

Second, the dynamic of the December crisis points out the fact that the Turkish financial supervision lacks credibility. The creation of the BRSA and its first months of activity have clearly initiated a change in practices. But, building a new credibility in banking supervision takes time and caution. In this context we consider very positive the decision to tackle the issue of connect lending in Turkey more courageously and can support the postponement until February of the issuance of regulation. In this context, we believe that, such as in the case of the regulation on internal risk management, there should be a lot of efforts to explain and clarify the authorities' intentions to market participants in order to avoid a new crisis of confidence and secure a higher level of PSI.

Finally, as the staff rightly points out, markets are still anticipating a devaluation in the coming months. Indeed, there is now an urgent need to curb significantly the inflation rate to buttress the credibility of the exchange rate regime. We note with satisfaction that the Central Bank of Turkey has swiftly tackled the issue of excess liquidity injected during the crisis but this should be seen only as a first step.

Ms. Ongley made the following statement:

The Turkish authorities have made the required efforts since the crisis and have given the essential policy responses that were needed. However, there are still significant vulnerabilities. There is much we could say with monthly reviews, but we need to focus on the most pressing points, which are the pattern of capital flows and the vulnerability of the banking system.

On capital flows, I join other Directors in celebrating the performance of capital inflows and the corresponding increase in foreign exchange reserves, which are in line with the NIR targets. I do not share the concerns expressed by Messrs. Yoshimura and Le Fort in this regard, particularly in view of the staff representative's confirmation that the targets were met with comfortable margins. However, the variability experienced in the exchange rate in the last few days, and the perception that capital inflows have been largely of a short-term nature, imply a high risk of a reversal in capital flows. While it would be premature to draw any conclusions regarding the intensity of the risk, this will need to be closely monitored in order to obtain a more detailed analysis of the situation. In particular, I wonder what interplay there might be with the current debt repayment schedule. Will there be any repayment spikes? Like Mr. Azoulay, I wonder what risks this poses to the achievement of the required rollover rate. Continued vigilance by the authorities concerning the smooth implementation of the program will be critical to rebuild confidence and avert financial difficulties.

Turning to the banking system, the authorities deserve credit for the takeover of troubled banks. However, I wonder if the authorities will be able to accelerate efforts after such a decisive step, with the aim of completing the resolution of the banks before end September. It is important that the authorities' actions prevent negative developments from arising elsewhere in the banking system. In this regard, I agree with Messrs. Pickford and Siegenthaler that we should focus on monitoring healthy banks in the future. We emphasized in the December 2000 meeting the importance of strengthened prudential regulations and risk management. The authorities committed to have the BRSA address this issue. The staff report points out that all banks comply with the ceilings on foreign exchange exposure, but I stress the point we made in December that it is the quality of the coverage that counts.

Like other Directors, we continue to have reservations about the bank deposits guarantee. While we accept that it is necessary in the current circumstances, the existence of the guarantee implies risks, including the potential for large fiscal costs and the lack of clarity over its removal that Mr. Pickford has indicated. I also have concerns, like Mr. Faini, about the ability of the CBT to mop up liquidity to prevent a breach of the NDA target. Comments from the staff on this issue would be welcome

To conclude, I would like to indicate that we support the review and approve the waiver.

Mr. Alosaimi made the following statement:

Turkey's implementation of the agreed policies helped in restoring the financial stability. The situation, however, remains fragile and fraught with risks as detailed in the staff paper. In this regard, I urge the authorities to strengthen their efforts to minimize those risks. As I am in general agreement with the staff appraisal I will limit myself to four brief comments.

First, the over performance regarding the net domestic assets is welcome. Removing the slack under the NDA ceiling is reassuring signal regarding. Given the current exchange system, reducing inflation is essential to limit real appreciation and enhance confidence.

Second, I take note of the advances made in restructuring the banking sector. The progress in resolving the situation of the intervened banks and the emphasis on strengthening supervision and prudential regulations are welcome. These efforts need to be continued and the combination of high interest rates and a weakening economy will likely increase the challenges.

Third, it is important that privatization of Turk Telecom is completed in a timely fashion. Here, I am encouraged by the progress made thus far and by investor interest in the company. It is essential, however, that the law allowing the transfer of management rights to minority shareholders be handled on a priority basis. I am also encouraged by the improved prospects for the sale of Turkish Airlines.

Fourth, it is unfortunate that the political outlook remains uncertain. This could complicate the efforts to restore investors' confidence and undermine the success of the program.

With these remarks, I support the completion of the fifth review and wish the authorities success.

Mr. Faini doubted that phasing out the guarantee for bank deposits could work before the banking system restructuring process was completed. Announcing a precise timetable for the removal of the guarantee would be equivalent to announcing devaluation. The authorities' strategy of keeping the guarantee until the situation had been stabilized, and the banking sector had been strengthened, would likely be the only viable option.

Mr. Esdar made the following statement:

We support the completion of the review of the arrangement and the request for the waiver, based on the expectation that the necessary decision in the electricity market will be taken as soon as possible. While reaching a firm conclusion on the assessment of the program with just a few weeks of track record is not possible, developments are certainly moving in the right direction. Policy implementation has been generally in line with the program's commitments, both in the structural and in the fiscal and monetary areas.

The recent fluctuation of capital inflows and reserves, however, shows the fragility of the situation and underlines the need for continued commitment to the program. There are significant political risks, particularly for the implementation of private sector reforms and privatization, but also in the macroeconomic area, given the high inflation and its effect on the sustainability of the exchange rate arrangement. There are also risks related to the impact of high long-term interest rates on the budget, and on growth. There is already some indication that growth might be weaker than expected. The need for a tight monetary stance to fight inflation and allow the external debt to be refinanced, the ongoing real appreciation of the exchange rate, and the slowdown of the economy will affect growth expectations. The situation will need to be carefully considered in the next review despite the positive signs noted by Mr. Faini, such as potential positive developments in Europe and the reduction in oil prices. Against this background, we welcome the tightening of the NDA ceilings and the fact that the program objectives in this area have been met. For the time being the foreign exchange reserves situation is stable, but a significant inflow of capital might cause problems in the future, and monetary objectives might have to be revisited.

Restructuring the banking sector remains the main challenge. While progress has been made by the BRSA with the 11 banks that were not meeting their obligations, I join other Directors in calling for the prompt implementation of the remaining measures required to restructure the banking sector. We are somewhat concerned about the news on political opposition against the restructuring of state banks. Perhaps the staff could shed some light on this matter. Regarding Mr. Faini's point on the guarantee scheme, while it will certainly have to be removed to avoid the perpetuation of its negative effects, we think that this can be done only once the restructuring process has been successfully implemented, as an earlier removal would be equivalent to an announcement of devaluation.

On privatization, we welcome steps to sell the telecommunications and airline operators, despite the investors' subdued interest thus far. The possibility that the sales might not be successful despite the institutional and structural measures already taken would need to be incorporated into the analysis of the alternative scenarios for the fiscal situation.

Mr. Varela made the following statement:

I would like to commend the Turkish authorities for the prompt and decisive actions taken since last December. Developments on the financial markets are showing that the risk of a major crisis is subduing. The Fund support has been instrumental to achieve that result, and the management and the staff must be also commended for their work and right appraisal of the underlying forces and correct policy recommendations.

Paradoxically, although the Turkish economy remains fragile and it is still subject to many vulnerabilities, it looks like now the circumstances for a successful implementation of the program have improved compared to the situation in late November.

As it was pointed out in the staff report for the Third and Fourth Revision Under the Stand-By Arrangement, the three main risks at that time were the impact of external shocks, policy implementation slippages, and stronger than expected domestic demand. Now once the late 2000 confident crisis is starting to be overcome, the Turkish economy might benefit from a much calmer external environment, given the present trend of international oil prices, international interest rates, and dollar exchange rate. Domestic demand has cooled down and the authorities are acting in a more decisive and disciplined way.

The ultimate target of inflation reduction could also be helped by improved circumstances. Inflation inertia might not be so strong in 2001 as it was in 2000. Less pressure on domestic demand may help as well to contain prices, coupled with a likely reduction in the energy costs. Lower inflation will reduce real exchange rate appreciation further limiting a negative impact on the output.

High interest rates are obviously a risk now with clear implications for growth and the banking sector. However, the evolution in the financial markets since December has been positive, and further reductions could be expected. Moreover, it is highly likely that the monetary framework, acting as nominal anchor, will continue to exert a downward pressure on the interest rates as last year’s experience demonstrated.

The main macroeconomic policy issue will continue to be building sufficient credibility for the monetary policy and therefore ensuring a smooth passage to the new exchange rate regime in the months ahead. The measures taken so far are welcome, particularly the elimination of the slack under the NDA ceiling to increase the predictability of the monetary policy. The strictly enforcement of the peg is a must, but from now on it is critical that all legal and institutional measures needed for the new exchange rate regime become promptly operational, especially the new Central Law envisaged for end-April, as well as the swift implementation of the policies to address vulnerabilities in the banking sector.

The measures taken in banking and privatization go in the right direction and we encourage the authorities to continue their efforts.

Strengthening the banking sector is of the essence to restore market confidence and to be ready for the new exchange rate regime. We join other directors in urging the authorities for a rigorous execution of the program on this area and for a more focused attention on improving supervision and control of connected lending and its implications in the forward exchange market.

This chair supports the proposed decision and the waiver on the non-observance of the structural benchmark to the electricity market law.

Mr. Jadhav made the following statement:

The authorities have made considerable progress in overcoming the economic crisis. This has been facilitated by the Fund's decision to provide resources to augment the authorities' crisis management capacity. While some calm has returned to financial markets there is no room for complacency, given that the situation remains fragile, as the staff and several Directors have emphasized. It is too early to consider that the return of investors to the country is significant. A further strengthening of market confidence is needed. We fully agree that lowering the NDA ceiling and raising the NIR floor increases the predictability of monetary policy and it signals that the authorities are committed to reducing inflation. In general, we feel that the measures envisaged in Mr. Kiekens' helpful statement are steps in the right direction that will greatly help the economy if they are implemented fully and meticulously.

With these remark, we support the proposed decision and wish the authorities success in the policy challenges that lie ahead.

Mr. Ondo Mañe made the following statement:

We would like to join other Directors in commending the Turkish authorities for the progress achieved so far, as almost all the targets set under the December Letter Of Intent for January 2001 were met.

We are also pleased to note that the recent turmoil that affected the financial markets has eased somewhat, indicating a gradual return of confidence. However, as indicated in Mr. Kiekens's preliminary statement, the situation remains fragile, and the program must be implemented fully and on time.

We commend the authorities for the actions taken to date. These actions have among other achievements, allowed the Central Bank of Turkey (CBT), to recover a significant portion of the reserve losses incurred during the crisis.

This excellent performance, supported by the entire international community, is a positive sign of the strong commitment of the authorities to the implementation of the program, in the critical areas of public finance and monetary sector, as well as with regard to market reforms, particularly in completing or advancing the privatization program.

In this context, we urge the authorities to complete sooner than later the overdue enactment of the electricity markets' law, as well as the regulation defining the connected lending, and welcome the steps taken with regard to tobacco company.

Moreover, as reforms in the banking and financial sectors are essential in restoring lastly market confidence, we welcome the steps taken by the authorities to clarify the depositors and creditors guarantee, the resolution of the 11 Savings Deposits Insurance Fund (SDIF), the strengthening of prudential regulations, and the reform of the four state-owned banks.

We believe that maintaining a tight control over the financial sector will be of critical importance, as it will also help in strengthening business confidence and preserve the Turkish economy from further turbulences.

With regard to recent macroeconomic developments and taking into consideration the staff's useful introductory remarks related to the program conditionality implementations, we would like to stress the important need for the authorities not to hesitate to take additional action, so that the policies remain credible, in light of the volatility of markets' assessment.

With these remarks, and as we agree with the staff recommendations, we support the proposed decision and wish the authorities success in their endeavors.

Mr. Abbott, referring to the point raised by Mr. Faini on maintaining the guarantee on deposits until the banking sector reform had been completed, observed that there was need to make speedy progress in the reform. On the related issue of bank restructuring and debt management practices, clarification from the staff would be welcome on the treatment of government bonds issued for the securitization of state banks' duty losses and for the resolution of banks taken over by the authorities. The view expressed in Paragraph 23 of the staff report was that those bonds should be as liquid and attractively priced as those issued at auctions, with the qualification that they should not jeopardize the government's domestic borrowing program. The high degree of liquidity for which the staff was calling could put pressure on the monetary and debt management policy. One would have expected the Fund to prefer somewhat more illiquid bonds, which would be consistent with the practice of treating those transactions as quasi-fiscal operations rather than as direct fiscal operations. Perhaps the staff could clarify this issue in their following mission.

Mr. Sutt made the following statement:

I join other Directors in commending the Turkish authorities for the expeditious implementation of a difficult reform agenda. This effort has yielded to some stabilization and restoration of market confidence. However, the sentiment remains weak and gains are easily reversible. Against the background of significant risks – stemming both from domestic and external factors – the market's tolerance level for policy slippages is likely to be minimal.

At this stage of the discussion, let me make just four observations. First, I share the concerns expressed by several Directors with respect to the short-term nature and composition of capital inflows. The fact, that the increase in capital inflows primarily reflects the borrowing activity of state entities and a very short-term borrowing by the banks, demonstrates well that the private sector's readiness to invest into Turkey remains limited. Furthermore, this composition of inflows might result in an increase in the government's contingent liabilities. Thus, the authorities should remain vigilant in monitoring the situation.

Second, on the issue of the debt monitoring system, the staff note in Box 1 that the present system does not cover repossessions and other off-balance sheet commitments. I wonder whether the staff has any estimate about the size of those commitments?

Third, progress with bank restructuring remains crucial for the success of the program. In this context, I join other Directors in emphasizing the importance of the efficient resolution of problem banks, as well as the significance of upgrading the regulatory framework, particularly the need for a swift implementation of the regulation on connected lending. Mr. Cottarelli's confirmation today that the authorities have approved the regulation on banks' internal risk management systems and relevant provisions in the capital adequacy framework is therefore most welcome.

Finally, regarding the issue of private sector involvement, I would like to associate myself with the views of Mr. Siegenthaler.

With these remarks I support the proposed decision.

Mr. Milton made the following statement:

We welcome the improved situation resulting from the authorities' policies that have brought the financial markets back to stability. The foreign reserve position has improved, interest rates have fallen and the stock market has recovered some of the losses stemming from the crisis. We welcome the authorities' continued commitment to the program. Among the recent

> measures taken I note in particular the improvement in risk assessment through the introduction of early warning systems and other improvements in risk management. However, it is clear that major challenges still remain.
>
> I would emphasize three main areas of concern. The first one is market confidence, which remains tenuous despite the recent improvement, as evidenced by the high interest rates for short-term borrowing and by the foreign exchange position. The second area is the real economy, where we are beginning to see a slowdown at a time when the global economy is showing signs of weakness. A slowdown could negatively affect the staff's assumptions on revenue and the general business sentiment. The third element is inflation, which remains high despite the progress that has already been made.
>
> Against this background, we take some comfort in the fact that the program remains firmly on track, according to the staff appraisal. However, the significant risks call for the elaboration of an action plan specifying how the authorities should react to a stronger-than-anticipated economic downturn in an environment of continued fragility in financial markets, given that the staff report does not provide much guidance in this respect. I conclude by saying that I support the completion of the review, and the waiver requested by the authorities.

The staff representative from the European I Department, responding to questions on the political situation, clarified that a decision on the potential closure of the Virtue Party would not be made by the government, but by the constitutional court. In fact, it had been reported in the press that the government was working with the opposition to reach an amendment to the constitution which could resolve that situation.

Regarding the concern over the fiscal implications of the recapitalization of banks raised by Messrs. Azoulay and Wei, the staff representative clarified that the cost of restructuring the state banks was already included in the fiscal accounts. However, the cost of recapitalizing private banks, which had been estimated to be at the order of $3.5 billion, was not included. In the current macroeconomic situation, with an expected decline in the debt-to-GDP ratio of 5 percentage points in the year 2001, the implications of these costs for the fiscal accounts were limited.

On the risks related to the roll-over of debt, the staff representative observed that the roll-over of domestic debt was much more uneven than that of external debt. While February would be a difficult month as a result of the large amount of debt that would come to maturity, the receipt of over $2 billion in revenues from the privatization in the year 2000, and the issuance of euro 500 million in eurobonds would help even out the spike in financing needs. March and April were not expected to be problematic months in that regard, as the amount of government bonds reaching maturity in those months was limited. The end of spring would likely be the most difficult period.

On Mr. Abbott's question on the liquidity of the securities issued to recapitalize banks, the staff representative stressed the need to differentiate between banks that had been taken over because they had failed to meet their obligations, and state banks. As far as the intervened banks were concerned, securities issued to finance their resolution would have to be sold on the market or to other banks, which were unlikely to buy securities that were not as liquid as those already in circulation. In the case of state banks, the situation was somewhat different, as the restructuring of these banks would likely involve their downsizing and some shift of their positions to other banks. It was true that, in the case of state banks, the securities would, in principle, not have to be as liquid. However, as state banks had already received rather illiquid bonds, new bonds would have to be highly liquid if an adequate total level of liquidity were to be reached.

The Director of the Monetary and Exchange Affairs Department informed that the authorities had started the process of downsizing the banks in transition in September 2000, as this had been considered necessary for their successful sale. While the stress tests in the banking sector since the last update showed that interest rates had fallen slightly, and that the situation had somewhat improved, the staff would be able to provide a more thorough update after the forthcoming mission, when a full set of stress tests would be performed based on up-to-date data—including data on loan portfolios. According to the data that were currently available, the amount of non-performing loans in the banking system was low, particularly when excluding the banks that had already been taken over. The ratio of non-performing loans to total loans was roughly 5 percent, which was a low number when compared to crises experienced in other parts of the world. The stress tests that would be performed in the forthcoming mission would likely not provide a very different picture on the situation of the banking sector.

On the phasing out of the guarantee for depositors and creditors, the Director assured the Board that the guarantee would remain in place as long as that was required for the restructuring of the banking sector, and would then be removed with prior notice to the public. Committing to a date for the phasing out of the guarantee without knowing if the banking system would have been completely restructured could result in great distress for the entire sector. The decision should only be taken after positive results had been obtained for a set of thorough stress tests that provided the necessary confidence that the banking sector was in sufficiently robust condition. Once that was ensured, the announcement of the phasing out of the guarantee some time in advance would not damage the confidence of the public and of international markets. The overall cost of the guarantee was difficult to estimate, given that the estimation required making counterfactual assumptions on the potential consequences of not having provided the guarantee. However, the available evidence indicated that there would have been runs on many banks in the absence of a guarantee for deposits and creditors. Therefore, the cost to the state of resolving the crisis once it had unfolded would have been much higher than under the alternative approach of introducing a preventive measure in the form of a general guarantee aimed at providing the system with the additional time required to restructure. On the other hand, it was also important, as Mr. Abbott had pointed out, to make speedy progress with the restructuring process to allow for a rapid removal of the guarantee, as the continued presence of a guarantee could also have negative effects on the banking system. The importance given in the program to the enhancement of prudential measures in the banking system was motivated by the need to prevent the risk of moral hazard, arising as a result of the existing guarantees.

On the liquidity of government securities issued to finance the recapitalization of the banking sector, the Director stressed the need to issue bonds that reflected the market's demands. The aim of bank restructuring was to turn troubled banks into viable banks and also into banks that could be privatized. Issuing bonds with reduced liquidity that were not attractive to the market would result in the need for additional funds to bail out banks that would be damaged by the low market valuation of those non-tradable bonds, as the experience with the privatization of banks in other countries had shown. While that did not mean that the maturity of the bonds should be extremely short, issuing ten-year zero coupon bonds for which there was no demand would delay the resolution of the banking system's problems. Banks would have to be recapitalized again in the future if the authorities decided to privatize them. That did not mean that floating rate notes should be issued exclusively, and bond portfolios should be structured in a fairly normal fashion.

Mr. Kiekens made the following concluding statement:

> It is striking that every contributor to the discussion focused on what Turkey needs to do to avoid a new financial crisis—primarily strengthening bank regulation and supervision and speeding up privatization – but paradoxical that none discussed in any detail what Turkey needs to do to achieve the primary goal of the program—bringing inflation down on schedule.
>
> Granted, any new financial crisis would threaten disinflation. Avoiding new market turmoil is absolutely essential.
>
> We must certainly not be complacent about the fragility of the banking sector. But the administration and particularly the IMF must avoid any panic reaction to the situation of Turkey's banking sector. Open foreign currency positions and connected lending have been at least as pervasive in the past as they are today. Despite these fragilities, Turkey withstood strong tensions in the international markets during the Asian and Russian crises without a formal guarantee for creditors of Turkish banks. Today, with a formal guarantee in place, and considerable progress, achieved and expected, in the banking supervision, the program would be damaged more if the inflation target were missed by a considerable margin.
>
> The surprising lack of in-depth discussion about how to reach the inflation target may suggest that the Board agrees with the program strategy. On this point Mr. Varella was probably the most outspoken when he distanced himself from the concerns of other Directors about the slowing of output growth. He considers the slowing as helpful for disinflation.

> Except for Mr. Yoshimura and Mr. Lefort, the Board agreed with the lower NDA ceiling and higher NIR floor. These actions show once more that the central bank is committed to continuing a tight monetary policy. They should both bring inflation down and create conditions for a lasting reduction of interest rates, which will lighten the interest burden on the budget.
>
> It is now more critical than ever to reduce the public sector borrowing requirement. Until 1998, large fiscal deficits did not increase the public debt-to-GDP-ratio, since the high inflation tax eroded the real value of the debt stock. But today, such erosion has been much reduced. Now, an increasing real interest burden could more easily trigger destabilizing debt dynamics. Credibility of policies to reduce inflation and real interest rates is crucial. The Turkish authorities do all they can to enhance this credibility, and I am confident they will succeed.
>
> Mr. Abbott was right to challenge the staff's position that the government bonds issued both for securitizing state banks' duty losses and resolving SDIF banks should be as liquid and attractively priced as those issued at auctions. I agree with Mr. Abbott that this was not necessary when Asian banks were recapitalized. I think a more balanced solution is advisable. The aim should be to help the recapitalized banks get a sound balance sheet. This will require a sufficient amount of liquid assets. But for large banks, a permanent stock of valuable but less liquid assets go just as far as to resolve these banks' solvency problems without disturbing sound liquidity management. In sum, the liquidity of the recapitalization bonds to be issued will greatly depend on what is needed to achieve an asset/liabilities structure consistent with prudent banking.
>
> Obviously, there are no easy solutions for difficult problems. But with continued determination on the part of the Turkish authorities, and strong support of the Fund and the World Bank, I am confident that full market confidence will soon return.

Mr. Esdar noted that, during the Board discussions, several Directors had pointed out that monetary policy should be kept tight to contain inflation, although that policy advice had been somewhat constrained by the combination of exchange rate and monetary policies.

The Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They noted that the strengthening of the authorities' program undertaken in late December, 2000 had helped rebuild market confidence and enhanced the credibility of their disinflation program, which had been shaken by the recent crisis. As a result, capital inflows have returned, interest rates have declined, and the Central Bank of Turkey's (CBT) foreign exchange reserves have been restored. Since the electricity market law would be approved with only a small

and justifiable delay, Directors agreed to the authorities' request for the waiver of the related performance criterion, and completed the fifth review under the Stand-by Arrangement. Nevertheless, Directors pointed to persistent and significant macroeconomic and financial risks and the need to continue and deepen the strict implementation of the program to sustain the recent improvements, as the situation remains fragile.

Directors noted that policy implementation since the last Executive Board meeting has been good. In particular, they commended the authorities for pushing ahead with critical actions in the structural area, including in banking, and on their close adherence to the monetary policy framework as laid out in their December 2000 Letter of Intent.

Directors stressed the importance of vigorous implementation of banking sector reforms. They welcomed the protocol between the treasury, the central bank, and the deposit insurance fund on the financing of the deposit and credit guarantee announced in December, as well as the steps required to strengthen discipline in the sector and to accelerate its restructuring. In particular, they noted that the recent decision to resolve the intervened banks that had not generated market interest should help restore confidence in the system and facilitate the reduction of interest rates. Similarly, they welcomed the strengthening of regulations aimed at addressing market risk and the expected tightening of regulations on connected lending. However, Directors noted that, in addition to adequate regulations, there was a need to implement bank supervision strictly, including by intervening rapidly to isolate any troubled bank from the rest of the banking system. They stressed the need to be especially watchful about the exchange rate risk of banks. The progress made in supervision since the establishment of the new Bank Regulation and Supervision Agency is encouraging, but more needs to be done. On PSI, Directors were encouraged by the high roll-over rates, and noted the need for careful monitoring of capital inflows, as much of these recently had been of a short-term nature.

On monetary policy, Directors noted that the CBT has successfully mopped up most of the excess domestic credit created during the crisis, thus helping restore market confidence as evidenced by the fall in interest rates and the increase in foreign reserves. They welcomed the authorities' decision to tighten the NDA ceilings set in December, as well as their continued commitment to keep net domestic assets below the program ceiling, should this be needed to avoid excessive money creation.

Directors welcomed the steps taken under the program to facilitate the privatization of the telecommunication, transportation, and energy sectors. As regards the latter, Directors supported the request for a waiver of compliance with the performance criterion relating to the enactment of the electricity markets law, as it was delayed for reasons beyond the control of the authorities. Directors noted that, because of weak international market conditions, privatization receipts may fall short of the program's targets, which would be a matter of concern for the budget. They encouraged the authorities to press ahead with their privatization program.

Directors stressed the persistence of the risks to the program. Despite strict adherence to the monetary policy framework and strong measures in the banking area, market confidence has not been fully restored, as evidenced by still relatively high interest rates in the money market and the short-term nature of recent capital inflows. They noted that high interest rates for a sustained period might hurt banks and corporations, increase the budget deficit, and push the economy into recession. They emphasized that the strictest implementation of the program's policies was essential to mitigate these risks.

The Executive Board took the following decision:

1. Turkey has consulted with the Fund in accordance with paragraph 3(e) of the Stand-By Arrangement for Turkey (EBS/99/225, Sup. 2), as amended, and paragraph 62 of the letter dated December 18, 2000 by the Minister of State for Economic Affairs and the Governor of the Central Bank.

2. The letter dated January 30, 2001 from the Minister of State for Economic Affairs and the Governor of the Central Bank and the letter dated February 2, 2001 from the Minister for Economic Affairs shall be attached to the Stand-By Arrangement and the letters dated December 9, 1999, March 10, April 27, June 22, and December 18, 2000 shall be read as supplemented and modified.

3. Accordingly,

(a) the ceiling on net domestic assets and the floor on net international reserves of the central bank for February 28, March 31, and June 30, 2001 referred to in paragraphs 3(a)(ii) and 3(a)(iii), respectively, of the Stand-By Arrangement shall be as set out in Annexes A and B to the letter dated January 30, 2001.

(b) paragraph 3(c) of the Stand-By Arrangement shall be amended by adding ", or" at the end of paragraph 3(c)(xvi), and by adding the following immediately thereafter:

"(xvii) by February 15, 2001, enacting an electricity markets law, as specified in paragraph 36 of the letter dated December 18, 2000 and the letter dated February 2, 2001."

4. The Fund decides that the fifth review contemplated in paragraph 3(e) of the Stand-By Arrangement is completed and that Turkey may make purchases under the arrangement, notwithstanding the nonobservance of the performance criterion on the enactment of an electricity markets law set out in paragraph 3(c)(xii) of the arrangement:

(a) on the condition that the information provided by Turkey

(i) on the implementation of the measures specified as prior actions or conditions for completion of the fifth review in paragraphs 35, 50, and 53 of the letter of December 18, 2000,

(ii) on the announcement by the Savings Deposit Insurance Fund that, effective February 20, 2001, it will revoke the licenses of the banks for which there is no investor interest and close the majority of the branches of these banks within two months, and

(iii) on the agreement of the Turkish authorities with the Fund staff on measures to address the open foreign exchange position of banks in accordance with the recommendations of the joint study group established by the Banking Regulation and Supervision Agency and the Central Bank of Turkey, is accurate; and

(b) on the further condition that, with respect to purchases subject to the performance criterion specified above, the information provided by Turkey on performance under this criterion is accurate. (EBS/01/8, Sup. 1, 2/2/01)

Decision No. 12422-(01/12), adopted
February 5, 2001

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/01/11 (2/2/01) and EBM/01/12 (2/5/01).

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 98/53, 98/61, 98/115, and 98/130 are approved.

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by Advisors to Executive Directors, and by Assistants to Executive Directors as set forth in EBAM/01/9 (1/30/01), and EBAM/01/10 (2/1/01) is approved.

APPROVAL: October 2, 2001

SHAILENDRA J. ANJARIA
Secretary