November 15, 2001
Approval: 11/26/01

# INTERNATIONAL MONETARY FUND

## Minutes of Executive Board Meeting 01/85

10:00 a.m., August 29, 2001

## Contents

**Executive Board Attendance**

S. Fischer, Acting Chairman
S. Sugisaki, Acting Chairman

| **Executive Directors** | **Alternate Executive Directors** |
|---|---|
| S.M. Al-Turki | A.S. Alosaimi |
| | D. Ondo Mañe |
| | K. Kpetigo, Temporary |
| | P. Charleton |
| | J.A. Chelsky, Temporary |
| | D.C. Guinigundo |
| | H.-H. Jang, Temporary |
| | W. Szczuka |
| | S. Bonomo, Temporary |
| | F. Haupt, Temporary |
| | D.H. Kranen, Temporary |
| P.C. Padoan | B. Bossone, Temporary |
| | C.A.E. Sdralevich, Temporary |
| | Low K.M. |
| | H.E. Phang, Temporary |
| V.L. Kelkar | R.A. Jayatissa |
| | J. Prader |
| | I. Abel, Temporary |
| | S. Çakir, Temporary |
| | A. Jacoby, Temporary |
| | Å. Törnqvist |
| R. Quarles | A. Baukol, Temporary |
| | G. Bauche |
| | B. Couillault, Temporary |
| | M. Daïri |
| | Y. Lissovolik, Temporary |
| | S. Vtyurina, Temporary |
| H. Oyarzábal | F. Varela |
| | O.E. Garner, Temporary |
| | S. Alcaide, Temporary |
| | S.P. Collins |
| | N. Joicey, Temporary |
| | A. Maciá, Temporary |
| C.D.R. Rustomjee | |
| A.S. Shaalan | A.F. Al-Faris |
| Wei Benhua | Jin Qi |
| | A.Y.T. Wong, Temporary |
| J. de Beaufort Wijnholds | Y.G. Yakusha |
| | E. Azoulay, Temporary |
| | H. Toyama |
| | T. Komatsuzaki, Temporary |
| | D. Vogel, Temporary |

S.J. Anjaria, Secretary
A.S. Linde, Acting Secretary
Z.R. Ahmed, Assistant
J. Puig, Assistant
O. Vongthieres, Assistant

**Also Present**

IBRD: R. Hood, East Asia and Pacific Regional Office; P. Moreno-Lopez and J. Saba, Middle East and North Africa Regional Office; Asia and Pacific Department: Y. Horiguchi, Director; M. de Bolle, A. Elson, Y. Khatri, J. Lee, O. Liu, L. Valdivieso. European I Department: H. Poirson. External Relations Department: K. Meesook, V. Shastry, J. Starrels. Fiscal Affairs Department: G. Abed, M. Petri. Legal Department: R. Gordon, H. Krull. Middle Eastern Department: P. Chabrier, Director; D. Burton, Deputy Director; P. Callier, U. Erickson von Allmen, D. Fanizza, A. Furtado, D. Hardy, H. Joly, Ms. I. Karpowicz, M. Lazare, E. Martin, A. H. Mansur, Ms. M. Said. Monetary and Exchange Affairs Department: M. O'Brien. Policy Development and Review Department: M. Ahmed, Deputy Director; L.J. Lipschitz, Deputy Director; C. Beaumont, S. Kashiwagi, T.T. Schneider. Secretary's Department: Ms. S. Bhatia, P. Cirillo, L. Hubloue, K. Moran, J. Morco P. Ramlogan. Office of the Managing Director: A. Krueger, First Deputy Managing Director Designate; R. Moghadam, R. Sahay, R.S. Teja. Advisors to Executive Directors: S.A. Bakhache, M.P. Bhatta, W.-D**.** Cho, S.S. Farid, S. Kropas, J. Mafararikwa, M.F. Melhem, J. Milton, E. Nyambal, S. Rouai, K. Sakr, A.A. Tombini, P.H. Whitehall Assistants to Executive Directors: T. Belay, V. Bhaskar, J.G. Borpujari, P.A. Brukoff, N.J. Davidson, N. Davletov, T. Elkjaer, N.H. Farhan, M. Faulend, T. Hadded, B. Kelmanson, I. Kupča J.K. Kwakye, R. Maino, R. Manivat, T. May, G. Nadali-Ataabadi, L. Ocampos, K.S. Oo, P.R.D. Prasad, D. Radev, J.W. Ralyea III, A. Rambarran, Y. Saito, S. Urinbaev, Wei X., I. Zakharchenkov.

## 1. JORDAN—EXTENDED ARRANGEMENT—REVIEW, MODIFICATION, AND WAIVER OF PERFORMANCE CRITERIA

The Executive Directors considered a staff paper on the third review under the Extended Arrangement for Jordan and its request for a waiver of performance criteria (EBS/01/136; 8/13/01).

Mr. Shaalan submitted the following statement:

> Underpinned by prudent macroeconomic policies and sustained structural reforms in a number of important areas which are outlined in the staff report, Jordan's economic performance continued to strengthen in 2000 and thus far in 2001, as evidenced in key economic indicators. GDP growth picked up to close to 4 percent—a remarkable achievement in today's weak global environment, inflation remained very low, official reserves were maintained at very comfortable levels, and public debt declined substantially, with the foreign component declining by 10 percent of GDP. The near- and medium-term outlooks of the economy have also benefited from the reform efforts which contributed to sustained financial and external stability. In fact, the authorities are confident that economic growth will outpace current projections in view of the strong performance of industrial output and the fact that tourism activity has been maintained at higher levels than expected, with regional tourism offsetting the decline in this activity from other regions. The implementation of important structural reforms continues to strengthen the foundations for further improvements in both the fiscal area and growth prospects. This strong performance was achieved despite an unfavorable external environment that was characterized by deterioration in the terms of trade and an escalation of tensions in the West Bank and Gaza.
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> Reform efforts in the period ahead will aim at building on the above achievements through a further substantial fiscal consolidation and strong and well-focused structural reforms. Monetary policy will continue to be geared toward maintaining a low inflationary environment, in the context of a stable exchange rate, while preserving foreign exchange reserves at a comfortable level. The program is consistent with the government's medium term objectives of steadily reducing public debt as a percent of GDP and raising the rate of economic growth in order to create more employment opportunities.
>
> The Jordanian authorities have put in place a number of fiscal measures in 2000, consistent with the program in terms of both containing the deficit and improving the medium-term outlook by reducing public debt. However, the overall fiscal balance turned out worse than programmed due to unfavorable external factors that were beyond the control of the authorities as well as one-off factors. In particular, there was a significant shortfall in non-tax revenue on account of the substantially higher cost of imported oil which resulted in a decline in the oil surplus. This surplus turned out less than

expected and was almost 3 percent of GDP lower than in 1999. In addition, there was a shortfall in royalties from the phosphate company due to unfavorable developments in external markets. Another factor that contributed to the larger-than-programmed deficit was the inclusion in the 2000 deficit, as measured under the program, of "debt for development" spending which was part of a debt reduction agreement reached with foreign creditors. Furthermore, fiscal revenue as measured under the program excluded JD15 million of central bank profits which were accrued during the year, but transferred to the treasury accounts early in 2001. On the other hand, budgetary expenditures came in virtually as programmed and tax revenue generally performed well. Net privatization receipts, which amounted to over 7 percent of GDP, almost all of which was treated as financing and used to reduce the public debt.

It is well to note that in many other Fund-supported programs at least some of the privatization receipts, and in some cases all such receipts, are included in revenues. Taking all these accounting factors into consideration would put in context the actual magnitude of the fiscal restraint exercised by the authorities. Indeed, if a less conservative but still acceptable accounting methodology was used, the 2000 overall fiscal position would appear in a much smaller deficit, or even in surplus if all privatization receipts were counted as revenue. Regardless of the accounting methodology used, the fiscal efforts outlined above remain substantial, especially when viewed against the various adverse exogenous factors which affected revenue.

The government is planning an ambitious reduction in the overall fiscal deficit for 2001 amounting to about 2 percent of GDP. With this reduction, the overall deficit is targeted at less than 3 percent of GDP and is more than covered by privatization receipts. Much of this consolidation will come from the revenue side on account of adjustments in petroleum products prices, improved tax collection resulting from the newly enacted VAT system, and a resumption of phosphates royalty payments. While expenditure will remain constant in relation to GDP, its structure will improve with the share of current expenditure declining, and that of capital expenditure increasing in order to update the country's infrastructure, particularly in the area of roads, schools, hospitals, and clean water facilities. These outlays will constitute an important component of human resource development. Within current expenditure, the authorities are also determined to protect the share of social sectors. Public debt is envisaged to continue its downward trend on account of improved revenue and savings out of privatization receipts. Data available for the first and second quarters testify to the effectiveness of the government's efforts, and confirm the feasibility of the targets for the year as a whole.

The improved fiscal situation reflects in large part the substantial progress made over the last year in implementing important structural reforms in the fiscal area. The parliament passed the second stage of the GST law, effectively converting the GST into a VAT. It also recently passed new income tax and public debt laws which should help strengthen tax revenue and enhance the management of public debt.

In the period ahead, the authorities will focus their efforts on ensuring successful implementation of the VAT system and have already requested Fund technical assistance for this purpose. In addition, the authorities intend to review the domestic petroleum prices periodically and will adjust them as needed to protect the associated revenue. In this regard, I am pleased to inform the Board that the price of kerosene was increased by about 20 percent effective August 15, even though this was not required under the program. The government is also giving priority to reforming the public pension system and has formed working groups to design a reform strategy to be adopted by the end of the year. Fund technical assistance has also been requested to support this important effort. All these reforms are laying good foundations for achieving Jordan's medium-term objective of eliminating the overall deficit after grants by 2005 and generally creating an enabling environment to enhance the role of the private sector.

Monetary developments in 2000 reflected increasing confidence in the economy and the national currency, as well as large privatization receipts and other inflows. The demand for the Jordanian dinar was robust and the interest rate differential with the U.S. dollar declined. Foreign reserves increased significantly and monetary performance criteria for end-September and end-December were met with a comfortable margin. These positive developments continued thus far in 2001.

In Jordan's circumstances, the foreign exchange peg has been instrumental in achieving low inflation and a stable financial environment, which helped strengthen confidence and, therefore, is conducive to growth. While this policy has led to some appreciation in the real effective exchange rate, competitiveness appears to remain adequate as evidenced by the strong performance of manufactured exports which grew by some 23 percent in 2000. The central bank will, therefore, continue to target exchange rate stability in the period ahead while, at the same time, maintain reserves at the current comfortable level. These two objectives will largely determine the course of monetary policy. Within this framework, fiscal financing will be entirely through the sale of government securities in order to allow an ample margin for extending credit to the private sector to further promote its growing role in the economy.

The Jordanian banking sector is sound and all banks meet prudential regulations. To further strengthen the sector, the authorities have enacted a new Banking Law and issued new regulations tightening the margins for foreign currency exposure, credit concentration, and the classification of non-performing loans. A new Deposit Insurance Law was also enacted and a deposit insurance agency established. The authorities are now revising other bank regulations in light of the new Banking Law, including those related to ownership of equity in financial institutions and the establishment of bank branches domestically and abroad. The central bank is also working with commercial banks on expanding their services and upgrading their internal control systems.

Substantial progress has been made in the privatization agenda in 2000 and thus far in 2001. This included sales of shares in Jordan Telecommunications Company and several other companies, the privatization of the duty free, flight attending, and catering subsidiaries of the Royal Jordanian airline, and the selection of a consortium to build and operate Jordan's first private sector-run power plant. In the period ahead, the focus of the privatization effort will be on the power sector. The separation of the activities of the generation, transmission, and distribution companies will be completed and an independent regulatory body for the sector will be established. This will pave the way for the privatization of a big part of the sector in 2002. In addition, the government is actively seeking a strategic partner for Royal Jordanian Airlines, and will continue to dispose of its minority shareholdings in other companies as market conditions permit.

The government is attaching priority to public sector and public administration reform and has initiated a program for their modernization. Efforts in this area include simplifying work procedures and revising the public service by-laws. Furthermore, proposals to modernize budget formulation and financial management are now being considered and the World Bank has recently approved financial assistance to support the authorities' efforts in this area.

In conclusion, Jordan's economic performance and progress in implementing the reform agenda have been commendable, particularly when viewed against the unfavorable external conditions and increased tension in the region. Receipts from successful privatization efforts and other inflows, combined with a skillful public debt management, have helped achieve a marked decline in public debt and put it on a downward trend. The authorities are determined to continue their strong fiscal and structural reforms in the context of a prudent monetary policy aimed at ensuring stability in the external sector and low inflation. They wish to thank staff for their hard work, and for their most useful and candid advice.

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

We thank staff for an informative report and Mr. Shaalan for his substantive preliminary statement.

We commend the authorities for Jordan's good performance through June this year under the program supported by the extended arrangement, despite trade impediments with neighboring countries and setbacks to the Middle East peace process. Economic growth picked up, inflation remained low, and monetary policy was sufficiently flexible to maintain a comfortable level of international reserves. Important progress has been made in trade liberalization, privatization, and fiscal and debt management. The external current account position improved reflecting large inflows of UN compensation transfers and privatization receipts, with the latter facilitating a reduction in public debt. Fiscal imbalances widened, however, due to substantial nontax revenue shortfalls. The unemployment rate, which unofficial estimates put at more than 20 percent, and the sharp surge in poverty since the mid-1990s raise the risk of social unrest in a volatile region.

Against this backdrop and heightening political tensions between Israel and the Palestinian territories, Jordan faces the difficult challenge of engendering a more robust growth path. Under these circumstances, the authorities' objectives for a sustained rise in real per capita income and for the reduction of poverty and high unemployment calls for greater fiscal discipline, a continued firm monetary policy, and extending structural reforms to other areas of the economy, especially to the public pension system.

We support the broad thrust of the program for 2001 and its realistic objectives of modest growth, keeping inflation under control and maintaining a secure reserve cushion. Additional fiscal adjustment is needed particularly given the heavy public debt overhang. The fiscal deficit before grants at 6.8 percent of GDP this year is around the same level as programmed last year and as obtained in 1999. The staff indicates that the annualized budget deficit so far this year has exceeded the deficit targeted for 2001 as a whole. Therefore, the authorities need to strengthen budget execution and to enact further reforms to the fiscal system over the medium term in order to put the debt burden on a downward trajectory. In this regard, we look forward to the decision on reform options for the public pension system, and to further progress in rationalizing outlays in public administration and other government operations. On the revenue side, we note from Mr. Shaalan's preliminary statement that the authorities raised the price of kerosene this August and intend to periodically adjust prices for other domestic petroleum products, thereby reducing the budget's vulnerability to changes in the concessional price paid by Jordan of crude oil imports from Iraq.

The authorities are to be commended for continuing to protect social spending under the current program. Budgetary outlays on health, education and social programs, which amount to more than 8 percent of GDP, are very relevant to supporting an anti-poverty strategy. So too are the government's direct interventions to fight poverty through the expansion of the National Aid

Fund (NAF) and Social Productivity Program (SPP), the latter supported by the World Bank.

We note the steps taken to enhance fiscal monitoring and management, in particular the publication of a monthly report on budgetary operations by the fiscal monitoring unit and the reclassification of the government accounts with the banking system. We look forward to the implementation of recommendations of recent Fund technical assistance for classifying flows through nontreasury accounts.

Monetary policy remains appropriately anchored on the current exchange rate peg of the dinar to the U.S. dollar, and we concur with Mr. Shaalan that this arrangement has served Jordan well during periods of turbulence even though at the cost of relatively high official interest rates. We, therefore, support the authorities' more cautious approach to meeting the inflation target. The recent large cumulative appreciation of the real effective exchange rate needs to be countered, however, by improving competitiveness in key sectors through labor market and other structural reforms. In addition, the authorities should remain vigilant and stand ready to tighten monetary conditions accordingly to protect the credibility of the peg. Recent financial sector reforms, including the new Banking Law and the new Deposit Insurance Law, would help to enhance the soundness and efficiency of the financial system.

The authorities' track record on privatization has been impressive and preparations are already underway to enable private sector involvement in the electric power, air transport, and postal sectors. As in the past, privatization proceeds should be prudently used to reduce net debt. We, therefore, share staff's concern on the authorities' decision to allocate a significant portion of these receipts to a privately managed fund, and urge them to ensure that such a fund is managed transparently and on a commercial basis.

We commend the authorities for the progress made in improving the quality and coverage of statistics and, like staff, welcome their decision to further enhance the fiscal statistics through Fund technical assistance.

We welcome the simplification of conditionality under the program.

In fairly difficult circumstances, the authorities have maintained prudent macroeconomic policies and made good progress with structural measures. A comprehensive final Middle East peace settlement would undoubtedly improve Jordan's positive economic outlook over the medium term. In conclusion, we support the proposed decision and wish the authorities well in their endeavors ahead.

Mr. Callaghan and Mr. Cho submitted the following statement:

We support the completion of the third review under the Extended Arrangement, given the strong performance of the Jordanian economy in 2000, with macroeconomic stability and most of the program targets being met with substantial margins. The authorities should be commended for the sustained reforms in recent years which have contributed to this improved economic performance.

Admittedly, the Jordanian economy benefited last year from substantial UN compensation inflows equal to about 6 percent of GDP. Such exceptional inflows, combined with larger than expected privatization receipts helped finance the external accounts and contributed to a reduction in public debt, notwithstanding the fiscal deficit being higher than programmed. However it is not possible to rely on such exceptional inflows, particularly in terms of financing government expenditures.

With the benefits of the exceptional inflows waning this year, there is a particularly big challenge ahead on the fiscal front. In this respect, two program slippages are a source of concern; namely the higher fiscal deficit, and the belated passage of revised tax laws. The major reason that the fiscal target was missed in 2000 was due to revenue shortfalls, as noted in the staff paper. More timely remedial measures should have been taken.

That said, we note that the revision to the tax laws, particularly the introduction of a VAT, is already having an effect, contributing to an increase in tax revenue this year. The authorities are also prepared to defer capital expenditures if revenues will fall short of the programmed level. Under these circumstances, we would agree to granting waivers as proposed. However, we urge the authorities to make concerted efforts to identify as early as possible shortfalls in revenue and to take necessary compensating actions on a timely basis in order not to allow further slippages.

Reforms in the pension system and domestic petroleum pricing are clearly tasks which will have substantial impacts on the medium-term fiscal position. In this sense, we endorse staff's streamlining of structural conditionality centering around these two reforms. We also welcome the advice that the highest levels of government now recognize the necessary priority of these two policy reforms. We hope that policy actions will be followed as a matter of urgency. We also urge staff to provide any necessary technical assistance in formulating relevant policies. In particular, we would be interested in hearing about the contribution of the World Bank in advancing pension reform in Jordan.

Reducing unemployment and achieving a more efficient labor market is a major challenge facing the authorities. However, there is little discussion in the staff report on the issue of reducing unemployment, other than the observation in Box 1 that the unemployment rate would have been much higher than official levels if discouraged workers and the underemployed were included. We would be interested in staff's medium term projections for the unemployment rate and their assessment of the main challenges that remain in improving the efficiency of the labor market.

We concur with the authorities' view that the pegged exchange rate system has served the economy well, keeping inflation low and—as Mr. Shaalan notes in his preliminary statement—maintaining a stable financial environment. Importantly, the authorities' prompt action in adjusting interest rates has helped maintain the credibility of the pegged exchange rate system. Nonetheless, there has been a cost associated with this approach, highlighted with the substantial appreciation in the real exchange rate which has impeded the traded goods sector.

The authorities' emphasis on the importance of stability and the maintenance of confidence in the currency has an added dimension, given the increase in political difficulties in the Middle East. Nevertheless, we would endorse the concerns raised by staff that the current approach to monetary and exchange rate policy may have hampered export growth and private investment. It is true that manufactured investment has increased in 2000; however Jordan will need a substantial improvement in its export performance if it wants to lift economic and employment growth and ensure a sustainable external position. As noted previously, it is not possible to continue to rely on exceptional financing inflows.

Finally, we would appreciate clarification from staff in relation to recent loan classification and provisioning in Jordan. We welcome the strengthening of the loan classification standard and the tightening of the definition of problem loans from a 180-day to a 150-day rule. We note further that a 90-day rule will be implemented from the beginning of next year. However, we also note that during 2000 provisions fell from 45 percent to 35 percent of the classified loans. Is this because of forbearance given to newly-classified loans or because of a general relaxation of the provisioning regulation? If, indeed, forbearance is the main reason, then we would be interested to know how long it will be extended.

With these remarks, we wish the continued success of the Jordanian economy.

Mr. Wei submitted the following statement:

I would like to thank staff for an excellent and candid paper. I would also like to thank Mr. Shaalan for his very helpful and comprehensive preliminary statement. I commend the Jordanian authorities for consistently implementing macroeconomic policies in a prudent manner under the Fund-supported program. The country's recent economic indicators speak for themselves. Real GDP rose 3.9 percent in 2000, while inflation was contained to a below-programmed 0.7 percent. These achievements occurred despite the worsening terms of trade and appreciation of the real effective exchange rate. Looking forward, economic growth is forecast to edge higher with the benefits of structural reforms filtering into real activity, and inflation kept at bay. Let me focus my comments on a few policy issues.

On the fiscal front, the overall deficit before grants, as measured under the program, exceeded the program target in 2000 and was almost 2 percent higher than that in 1999. However, we should take into account the unfavorable external factors that have contributed to the outcome, especially the significant decline in the oil surplus—resulting from high costs of imported oil—and the shortfall in royalties from the phosphate mining company. Importantly, we note that budgetary expenditures came in virtually as programmed. We thus think that this kind of unintended fiscal slippage should be given special consideration and support the authorities' request for the waiver.

We welcome the introduction of the VAT system last January and the strong performance of tax revenue so far in 2001. We concur that the overall fiscal deficit target for 2001 is ambitious but achievable. We take comfort that the authorities will, within the guideline of maintaining expenditure in relation to GDP, continue to develop the country's infrastructure and, more importantly, take care of the social sectors. We welcome the Brady bond buybacks and debt swaps which have lowered Jordan's foreign debt, thereby reducing the external vulnerability of the country. We, however, agree with staff that the substantial UN compensation payments and proceeds from privatization in 2000 that boosted the external position were indeed exceptional and there is no room for complacency in terms of stepping up efforts in economic reforms.

We concur with staff and the authorities that the current exchange rate regime, supported by prudent macroeconomic policies, has continued to serve the economy of Jordan well. In this regard, we share the authorities' view that the regime has helped impose a strong discipline on monetary policy and anchor the economy to a very high degree of monetary (low inflation) and financial stability, thereby providing an environment that is conducive to economic growth and gains in competitiveness. This is evident in the recent strong growth of manufactured exports.

On the structural front, we commend the authorities for their consistent pursuit of market-oriented reforms which are already starting to bear fruit. The authorities' commitment to structural reforms ranging from trade tariff reductions, public debt management, strengthening of banking regulations, to privatization programs, is evident in their recent efforts. We support staff's recommendation for the waiver of the end-December structural performance criterion on the amendments to the income tax law. In addition, with the highest levels of the government recognizing the priority of reforms of the pension system and petroleum pricing, like Mr. Callaghan and Mr. Cho, we commend staff for streamlining the structural conditionality in these areas. The authorities are commended for taking the initiative in public sector reforms in a bid to improve efficiency. The financial and technical assistance provided by the World Bank in this connection is much appreciated.

With the above remarks, I support the completion of the third review under the extended arrangement and the proposed decision. I wish the authorities continued success in their future endeavors.

Mr. Rustomjee submitted the following statement:

We commend the Jordanian authorities for the continued effort to improve economic performance under difficult circumstances. During 2000, economic growth continued to rebound and inflation, maintaining a downward path, remained low. The external current account continued to strengthen, despite a sharp rise in oil import prices, owing mainly to large UN compensation payments related to Gulf War damage and higher workers' remittances and, consequently, official international reserves have further increased. The continued effort at pushing the privatization process forward and the resultant large privatization proceeds helped the reduction in public debt. Moreover, developments in the area of fiscal policy, particularly in enhancing tax revenue and containing budgetary expenditure, were generally encouraging, although the fiscal deficit was not in line with the program target due to shortfalls in non-tax revenues. Jordan's overall economic performance is indeed remarkable for a country with limited resources and narrow production base and for whom regional developments have not been that favorable.

We are encouraged that, so far in 2001, economic growth has continued to maintain a positive trend and inflation has further declined. We are also encouraged by the budgetary performance as it has been broadly in line with expectations and by the satisfactory developments in the area of monetary policy. As regards fiscal policy, we welcome the authorities' commitment to take measures that can help to more than compensate for the slippages in 2000. The fiscal target for 2001 represents a 2 percent of GDP improvement over the 2000 outcome. We, therefore, support the authorities' request for the waiver of the nonobservance of the end-December 2000 fiscal performance criteria. We also support the request for the waiver regarding the amendments to the income tax law, which have been delayed, as they have been approved recently.

We welcome the authorities' determination to continue to strengthen the fiscal position. The steady reduction in the fiscal deficit is of importance to bring down the debt burden which remains very substantial. In this regard, the envisaged reform in the pension system, which continues to place a heavy burden on the budget, and the anticipated changes in petroleum product pricing, which will bring more closely the domestic prices of petroleum products to the cost of imported oil, should strengthen fiscal performance over the medium term. Moreover, continued effort at structural reforms will also be critical in attaining a significant reduction in the public debt and a sustainable improvement in the fiscal position.

On exchange rate policy, we note the staff's preference for greater exchange rate flexibility. We also note the authorities' desire to continue to maintain the present regime of pegging the dinar to the U.S. dollar. The peg is said to have helped to enhance credibility in the local currency and to ensure a steady reduction in the rate of inflation. Moreover, despite the appreciation in the real exchange rate, manufactured exports have grown strongly. Such developments may justify remaining for some time with the current regime.

Financial sector reforms have enabled Jordan to particularly promote a sound and efficient banking system. To further cope with the requirements at the advanced stages of the transformation, we encourage the authorities to continue to move forward toward the adoption of international prudential standards.

We once again commend Jordan for its successes and wish the authorities all the best in their future endeavors.

Mr. Daïri submitted the following statement:

The well-written staff report and Mr. Shaalan's informative statement provide a clear overview of recent developments of the Jordanian economy and the challenges that lie ahead. Despite difficult external environment, macroeconomic and financial performance during the second year of the extended arrangement was encouraging. A broad-based economic growth exceeding the program target in a low inflation environment helped reverse the falling per capita income of recent years. Large privatization receipts, exceptional foreign assistance, and a proactive external debt management policy produced a substantial decline in the public debt ratio to GDP, while foreign reserves rose strongly above program projections. All monetary performance criteria were met with margins, and the Central Bank of Jordan (CBJ) returned to profitability in 2000 after several years of operating losses. With all commercial banks comfortably meeting the main prudential ratios at end-2000, the financial sector remained well-capitalized and profitable. Trade liberalization, continued privatization, the introduction of the VAT, and reforms of the income tax and public debt laws signaled important progress in the implementation of the structural reform agenda. We concur with the thrust of the staff appraisal and, in view of the authorities' renewed commitment to more than fully reversing last year's fiscal slippage, support their request for waivers and completion of the third review under the extended arrangement.

Reducing a high debt burden in the context of lower privatization receipts and foreign assistance hinges on fiscal consolidation over the medium term. The program appropriately targets an ambitious fiscal adjustment in 2001. The authorities are well advised to closely monitor fiscal developments. On the revenue side, efforts should continue to ensure a successful implementation of the VAT while progressively widening its scope. We support the authorities' request for Fund technical assistance to strengthen the VAT administration. We also welcome the recent price hikes for domestic petroleum products, and the planned quarterly reviews to adjust prices with a view to safeguarding revenue.

With an already high ratio of revenue to GDP, however, fiscal adjustment requires stronger efforts to rationalize and contain government expenditure within the programmed levels. We welcome the authorities' intention to reduce spending, if necessary, to meet their fiscal targets. While we note a virtually unchanged non-interest current spending in 2001, we commend the authorities for redirecting expenditure toward social outlays. Over the medium term, the reform of the pension system and modernization of the public administration could help raise the efficiency of public expenditure and alleviate the growing budgetary pressures. We welcome the recent formation of a high-level and a technical committee to design a public pension reform strategy, and support the authorities' request for Fund technical assistance. Moreover, the new public debt law will enhance domestic debt management, while the regular publication of a monthly report on budgetary operations will allow for increased transparency and a more effective fiscal monitoring. In this context, we join the staff in welcoming the authorities' decision to volunteer for a data ROSC.

As indicated by Mr. Shaalan, monetary policy will continue to aim at maintaining a low inflationary environment and a comfortable level of reserves in the context of a stable exchange rate. A minimal level and variance in inflation, as well as a high demand for the dinar, have given considerable credibility to the current pegged exchange rate regime. With continued robust growth in exports, there seems to be little evidence pointing to dampened competitiveness as a result of the current fixed regime. Over time, however, we agree with the staff's argument on the negative implications of the significant appreciation of the real effective exchange rate of the dinar on export growth and diversification as well as on the private investment. Accordingly, we reiterate our position that the authorities may wish to work toward a viable exit strategy to be implemented at an appropriate time from a position of strength. On the banking sector, updating the banking regulations in conformity with the new Banking Law and gradually adopting international prudential regulations will promote bank soundness and allow for a more effective financial intermediation.

To improve growth prospects and help raise the living standards through employment generation, Jordan needs to sustain the pace and broaden the scope of its structural reforms. Following the notable advances of the past two years, privatizing the power sector, finding a strategic partner for the state airline, and restructuring the postal service should promote a more efficient allocation of resources and remove some important impediments to growth. In the face of a burdensome public indebtedness, the use of privatization proceeds mainly to reduce net government debt is most appropriate. Moreover, while we note the authorities' intention to promote investment through establishing a privately managed investment fund later this year, we share the staff's view on the need for securing its efficiency and profitability.

Mr. Kelkar submitted the following statement:

We thank the staff for an excellent report for the review. We are also thankful to Mr. Shaalan for an exhaustive preliminary statement. We agree for waiver of both the performance criteria. We are encouraged to note that the GDP growth close to 4 percent has exceeded program projections. The per capita income has increased. We appreciate the reasons associated with conflict in the region and security environment that influenced setting up of a lower target for real GDP growth. We are encouraged to note that the manufacturing activity has grown by 6 percent despite reduced demand for exports from West Bank and Gaza. The inflation is controlled. The debt burden has come down. These achievements have come in the midst of a difficult environment. Though the security situation has discouraged tourists it has not come in the way of hotels, restaurant and other travel trade related activities. The construction activity is the only poor performer in the circumstances. We commend the authorities for steering the economy under difficult environment to achieve program targets. We agree with the staff that the program is consistent with medium term objectives of reducing public debt, raising economic growth to create employment opportunities. We are also encouraged that Jordan immediately after joining WTO in April 2000 has completed a series of tariff reductions. We look forward to see Jordan to receive benefits associated with increased integration sooner than later. In view of these achievements we support the staff recommendation to support waiver of the end December criterion on the submission to parliament, of amendments to the income tax law, which was approved in the just ended extraordinary session of parliament.

The successful carrying out of privatization is evident in the sale of Jordanian Telecommunications Company and share of several other companies which have brought-in substantial proceeds. Reforms in the power sector are also in offing. We are encouraged by the indication that the privatization proceeds are going to be used to reduce net government debt. In regard to the management of privatization proceeds we agree with the staff that it should be done purely on commercial basis. Further in regard to placing part proceeds with a privately managed investment fund we agree with the staff that, the uncertainty associated with such a fund could cause extra budgetary expenditure.

The UN compensation inflows amounting to 6 percent of GDP are exceptional. Such exceptional flows cannot sustain external economy. With possibility of deficit in balance of payments the authorities would be facing a challenge. We agree with the staff that increased price for crude oil imports has caused a setback to the fiscal management. We are encouraged that the government is undertaking to reduce the overall fiscal deficit of 2 percent of GDP in 2001. The government is aware of the need to relate domestic oil prices with import prices and intends to review the situation on a quarterly basis to achieve the objective. In this regard it is encouraging to know that, effective from August 15, the price of kerosene was increased by 20 percent. We agree with the staff that with introduction of VAT system in January 2001 and its good performance there would be significant achievement in the fiscal objectives in 2001. The government has also expressed its readiness, if necessary, to defer some of the planned increase in current capital expenditure while keeping current non-interest spending constant as a percentage of GDP relative to 2000 while retaining social sector spending. Therefore, we agree with the staff for the authority's request for waiver of the end December 2000 fiscal performance criterion.

In order to achieve fiscal adjustments revenue should also be enhanced. As such, we agree with the staff on the desirability of increasing the share of tax revenue while reducing reliance on nontax revenue. We are happy that the reforms are being launched with the assistance from World Bank to rationalize the public administration and improve efficiency of government services. Given the high ratio of government revenue to GDP it is critical for the government to limit expenditure. The pension burden on the budget is increasing and it is a cause of concern. We agree with the staff on the need for the government to adopt a strategy to reform the pension system to public employees. The formation of a high level and technical committee to study reforms options is welcome and we hope the pension strategy is expected by December 2001. We hope these efforts would enable the authorities to contain expenditure.

The banking sector is sound and all the banks meet prudential regulations. The new law on Banking, Deposit Insurance and new regulations tightening the margins for foreign currency exposure, credit concentration and efforts to upgrade internal control systems of the bank would further strengthen the system. Monetary performance has resulted in a decline in the interest rate differential with U.S. dollar and an increase in foreign exchange reserves. We are encouraged that the central bank would continue to target exchange rate stability and maintain reserve at comfortable level.

We are concerned at the fact that the pace of job creation is not keeping pace with changing demographic pressures. We request the staff to clarify on the long-term implications of growing unemployment and suggest remedial policy measures.

We wish the authorities all the success in their policy endeavor.

Mr. Al-Turki made the following statement:

It is indeed remarkable that Jordan's economy continues to perform so well despite the weakened global economic environment, and the continuing turmoil in the West Bank and Gaza. Growth remains robust in a sustained environment of virtually stable prices, falling public debt and comfortable external reserves. The outlook is also promising in view of the authorities' established reputation for macroeconomic prudence and persistence with structural reform. Given the high unemployment and rapid population growth, a sustained high growth is crucial for Jordan. Unfortunately, as staff rightly notes, further enhancement of the positive medium-term outlook for Jordan is tied to a factor beyond the authorities' control, namely, the success of efforts to reduce regional tensions.

The economy's recent and prospective developments and policy priorities are well laid out in the well-written and insightful staff report. I broadly agree that the present policy package is clearly working and should be implemented fully. Taking into account the overall program performance and the explanations provided for the deviations, I fully support completion of this review and grant of the authorities' request for waivers. That said, I will add the following remarks for emphasis.

First, I welcome the increased priority for fiscal action to sustain a steady decline in the public debt. This is particularly important in view of the end of transitory factors such as the inflow of UN compensation funds that assisted the fiscal outcome last year. Looking forward, I welcome the expected revenue growth from tax rationalization, including implementation of the VAT. Containment and improved efficiency of public outlays are, however, a priority. Here, I welcome the focus on containing non-interest current outlays to both shelter social spending and allow for a rise in priority capital expenditures. Progress on pension reform is also crucial. The challenge now is to implement the agreed policies fully. The steps taken for increased monitoring of budgetary developments are therefore welcome.

Second, I welcome staff's endorsement of the authorities' continued prudent management of monetary and exchange rate policy. As the report stresses, these policies have served Jordan well. Here, staff's recommendation nonetheless to move toward adoption of a flexible exchange rate is unconvincing at this time. To pursue this policy line, staff clearly needs first to counter the strong defense of the status quo in Mr. Shaalan's preliminary statement. Indeed, maintenance of exchange rate stability appears critical to sustain market confidence in the specific circumstances of Jordan and the uncertainties prevailing in the region.

Third, I commend the authorities' overall excellent record on structural reforms, including particularly privatization. As staff has stressed, Jordan also stands out in the prudent approach to disposal of privatization receipts. In that connection, I share staff's stress that any use of such proceeds in the future in a private investment fund should be on a strictly commercial basis. Regarding the ongoing power sector reforms, it is important to also take into account the experiences of countries with commercial separation of the generation, transmission, and distribution activities.

With these remarks, I wish the authorities further success.

Mr. Azoulay made the following statement:

We welcome the clear and candid staff document. The Jordanian authorities' achievements can be seen in almost all economic indicators. Jordan's success under the EFF is all the more striking given the unfavorable geopolitical environment that has prevailed since the fall of 2000. We commend the Jordanian authorities for continuing to pursue responsible macroeconomic policies. These policies are consistent with the authorities' commitments under the program and with their strategic aim of promoting macroeconomic stability and structural reform to achieve sustainable output and employment growth, integrate successfully into the global economy, and reduce external vulnerability. The authorities' greater focus on private sector led growth economic policy has already generated a turnaround in many areas, with economic outcomes better than expected under the program: GDP growth in 2000 accelerated to about 4 percent with prices remaining stable, external reserves increased, and skilful government debt management has markedly reduced the country's debt. These favorable developments have translated into a significant rise in credibility and a marked decline in interest rates.

The authorities' prudent policies will continue to greatly benefit Jordan's economy. As described by the staff in its medium-term outlook, economic prospects are positive, and the economy will look totally different in the next five years: GDP growth will accelerate to 5-6 percent a year; debt ratio will continue to fall to an unprecedented low level of about 50 percent by

2006; the external position will continue to strengthen, reaching a balanced current account; and the fiscal position will also improve markedly. Implementation of structural reform is impressive. The accelerated pace of reform and privatization should boost economic efficiency, enhance productivity and promote the private sector's role in the economy, thereby strengthening the country's economic fundamentals and increasing the economy's long-term growth prospects.

In our view, Jordan has committed itself to an ambitious, wide-ranging reform agenda. It will, however, be important for the authorities to proceed cautiously as they implement reforms. In particular, we recommend identifying priorities and carefully assessing the economic impact of every step in the reform program. We suggest that emphasis be given to sequencing the different reform stages so as to further solidify economic stability and to smooth the adjustment of consumers and other market participants to the changes introduced.

Sustained fiscal consolidation is key to reducing the government debt and maintaining the level of external reserves. Recognizing this, the government maintained expenditure at the programmed level in 2000 while also benefiting from good tax revenue performance. The government has also adopted an ambitious deficit target for 2001. It will reach this target based on its plan to reform the pension system for public employees, improve the effectiveness of public outlays, gradually adjust domestic oil prices and continue privatization. We share Mr. Shaalan's view, as expressed in his helpful statement, that these reforms will support Jordan's objective of strengthening its macroeconomic fundamentals.

On the exchange rate, although a more flexible exchange rate would help minimize the adverse effects of shocks, especially if the country becomes more open, like the staff, I believe that the current pegged regime does much to ensure macroeconomic stability, particularly price stability, and thus serves the country well. In my view, it should be retained as the country's nominal anchor for the next few years. We support Mr. Shaalan's view that competitiveness has remained adequate, and we believe that the authorities' continued implementation of reforms should improve competitiveness. Regarding an eventual move to a more flexible exchange rate regime, we suggest that the authorities undertake such a move only after careful examination and only after further progress has been achieved in developing the monetary framework, improving the functioning of the financial market, and streamlining the exchange rate market.

With these remarks we support the completion of the third review and the waiver for nonobservance of performance criteria.

Mr. Kranen made the following statement:

We would like to thank staff for the preparation of today's document and Mr. Shaalan for his preliminary statement. We support the proposed decisions. Despite the deterioration of the economic environment, Jordan has performed relatively well since the last review. GDP per capita increased for the first time in several years and the difficult fiscal situation was alleviated by generous support from the international community and privatization receipts.

Since we are in broad agreement with the staff appraisal I will confine my remarks to two points, the fiscal stance, and the exchange rate system.

On my first point, the fiscal situation in Jordan is still the Achilles heel of the future economic development of the country. The high debt burden is putting a drain on the budget and will limit the scope for additional expenditures for several years to come. It is therefore commendable that the authorities are committed to reverse this process and are striving to create breathing room by reducing the debt burden. The recent introduction of the VAT system, which has already shown first promising results, is a welcome step in the right direction. With regard to the pricing policy for domestic petroleum products we share staff concerns. Such a policy has aggravated the negative effects of oil-price shocks in the past and will increase Jordan's vulnerability to external shocks in the future. Although Mr. Shaalan has mentioned in his preliminary statement that the authorities have decided to raise at least the price of kerosene by 20 percent—which is commendable—a comprehensive approach to change, or better still, abolish the current practice of pricing domestic petroleum products is needed. The examples of several other countries have shown that such a policy severely hampers the control of public finances. It is also a pretty inefficient way of pursuing social objectives and the system is prone to misuse. The authorities should seriously consider abolishing the whole petroleum price control system instead of trying to fix it.

Coming to my second point, the exchange rate system, I have to admit that I was somewhat puzzled that on the one hand staff thinks that the Dollar peg has served the country well. On the other hand, however, staff argues in favor of moving to a more flexible system. Does the staff believe that the real appreciation in recent years due to the strong dollar will hamper the export sector to such an extent, that it justifies the abandonment of the exchange rate system, which has been managed well and has achieved a very high credibility? Or does staff expect that the external position is likely to deteriorate very soon due to declining grant inflows? If these developments are likely to occur and are going to cause problems of the magnitude that a change in the exchange rate policy might be justified, we should discuss them. However we should also not underestimate the possibility of a downward correction of the dollar, which is—according to the Fund's Research

Department—highly overvalued at the moment. Such a development would ease possible competitive disadvantages of Jordan. Against this background and the relatively good performance of the export sector, as pointed out by Mr. Shaalan, I do not see enough evidence to question the exchange rate system today, a system which has held inflation low and has contributed to a stable financial environment.

To conclude my statement Mr. Chairman, I would like to commend staff for its efforts to streamline the conditionality of the new program. As in all Fund-supported programs, it is the ownership of the authorities, which makes the program a success and not the number of criteria or benchmarks. Therefore, I would like to join Mr. Callaghan's assessment with regard to structural conditionality. Putting the two key policy reforms in the center of Fund monitored conditionality and leaving other important structural reform areas as for example the pension reform in the responsibility of the World Bank is the right approach.

With these remarks, we wish the authorities much success.

Mr. Bauche made the following statement:

The staff report adequately addresses the major economic challenges facing Jordan: fiscal adjustment, exchange rate policy, and structural reforms.

I have several comments on fiscal policy, which is an area rightly emphasized by the staff in the Fund-supported program for 2001. The authorities face crucial fiscal challenges in 2001, especially as last year's exceptional inflows of UN compensation payments and privatization receipts were windfall transactions.

We can go along with the proposed waiver for the end-December 2000 fiscal performance criterion in view of the authorities' commitment to reverse the fiscal slippages occurred in 2000.

For the period immediately ahead, I agree with the ambitious planned cuts in the deficit budget in relation to GDP, as a sustained reduction in the fiscal deficit is crucial to keep the public debt ratio on a downward trend. The authorities will have to adhere to the prudent expenditure plan incorporated into their program. Their intention to raise the efficiency of budgetary expenditure is also welcome.

On the revenue side, I agree with the staff on the need to maintain revenue growth in line with nominal GDP growth as a minimum condition to meet the authorities' fiscal adjustment targets. There is a lot of merit in the staff's suggestion to increase the share of tax revenues and reduce reliance on nontax revenues. At the same time, such measures need to be properly and appropriately phased in, especially in light of the difficult social context, with a large part of the population living below the poverty line.

I also commend the government's priority to reform the public pension system, as this poses a genuine threat to fiscal sustainability if not timely addressed.

Regarding the partial utilization of privatization proceeds to undertake debt buy-back operations, I would like to emphasize the importance for the Paris Club of the comparability of treatment principle.

As for the debate on exchange rate policy, I agree with the point made by Mr. Kranen regarding the lack of a clear position in the staff report on the adequacy of the current exchange rate regime or the need to move to a more flexible regime. I share the staff's concerns over the appreciation of the real exchange rate in recent years, but I also understand the authorities' view that the current peg has helped achieve a stable financial environment, and that it enjoys a good deal of credibility. We can support the authorities' prudent stance in this area provided that, as stated by Mr. Portugal, appropriate structural measures are undertaken to improve the competitiveness of the economy.

On structural reforms, I share the staff's concerns regarding the possible establishment of a privately administered investment fund to manage privatization proceeds, and I associate myself with the comments made by Mr. Al-Turki on this issue. More generally, I encourage the authorities to continue implementing the measures envisaged in their structural reform agenda. As explained in the staff report, many of these measures have already been launched in a large number of important areas.

With these comments, I wish the best to the authorities in their endeavors, particularly in light of the difficult environment in the region.

Mr. Daïri shared the concerns expressed by other Directors regarding the general approach taken by the staff to provide advice on exchange rate regimes to member countries. The lack of a clearly defined methodology could create confusion among market participants.

Mr. Sdralevich made the following statement:

At the outset I would like to congratulate the authorities for the progress made during 2000 and in 2001, well reported in Mr. Shalaan's informative preliminary statement. Despite challenging external circumstances, growth has picked up in a context of low inflation, the external situation has improved, and structural reform has been broadly advanced, notably in the fiscal area, the financial sector, and privatization. Our judgment of the efforts of the authorities is, in brief, positive. We support the proposed review and the waiver of performance criteria. We will focus our comments on two areas, that is, the application of streamlining of conditionality, and the difficulty in evaluating the economic situation.

With regard to conditionality, we are a bit perplexed by the extreme degree to which streamlining has been taken in this case. In the 2000 program, conditionality was composed by 2 structural performance criteria and 9 structural benchmarks, not counting the issuances of government securities, which constituted additional structural benchmarks. The 2001 program, by contrast, has only one structural benchmark. From this shift one could as well deduct that structural reform is not important in this Fund program. In fact, we believe that the contrary is the case. Structural reform in Jordan is extremely important for laying the basis for future growth, which at the moment depends to a large degree on external circumstances, as well as for dealing with the still very vulnerable fiscal position. Furthermore, the authorities' significant and laudable efforts in this field notwithstanding, the track record in structural reform is far from being perfect, as the long delay in taking this review to the Board attests.

As to the specific content of conditionality, we would have appreciated the carry-on of both the incomplete pieces of conditionality from last year's program, even though we take positive note of the staff's inclusion of approval of the pension reform strategy as a benchmark, which is certainly justified in light of its macroeconomic impact.

Turning to the economic situation, we note that it is very difficult to solidly interpret the developments in 2000–2001 given the presence of exceptional elements. In particular, UN transfers may have played a very significant role. The size of this temporary factor, 6 percent of GDP or a larger amount than net foreign grants points to the need of prudence in evaluating growth, which could have been boosted by a consumption rise fueled by the transfers; the behavior of the current accounts, that has been influenced both directly by the transfers, and indirectly through their effect on imports; and, lastly, the build-up in reserves, which have also been boosted by the inflows. These elements have been well underlined by staff, and in conjunction with the difficult external economic and political developments, warrant a note of caution in the optimism about the future economic performance of the country.

The effect of the exceptional transfers may make also difficult to interpret the extent of the loss of external competitiveness. During the last Board meeting on Jordan, we took the view that while there is undoubtedly some loss in competitiveness, it still did not justify the introduction of higher flexibility in the exchange rate regime. After having heard the arguments against and in favor of a change, on balance we are led to maintain this position. However it is important to be ready to take a swift decision if need be. It is therefore certainly necessary to keep the situation under constant monitoring.

Let me conclude by supporting the comments made by other speakers regarding the risks arising from the fiscal performance, which continues to represent a significant vulnerability. Without adding further to my statement, let me just join staff in recommending the authorities to continue to manage the privatization receipts prudently, with particular reference to the plan to employ a private fund manager.

With these comments we wish the authorities continued success.

Mr. Charleton made the following statement:

Firstly, I would like to compliment staff on a comprehensive clear report. I agree with the bulk of their analysis and support requested waivers and I will focus on only a few points.

But firstly let me acknowledge the efforts of both staff and the Jordanians to improve statistical reliability. Not so long ago much of Jordanian fiscal and output data were essentially fictional—to the point where the whole surveillance process was questionable. Thankfully, this seems firmly in the past.

The good news is also that the economy grew quite well in 2000—a rise in per capita income is a very welcome development. Structural reform is progressing steadily and the medium-term outlook is for growth in the 4-6 percent range. A figure towards the top of that range may be essential to maintain social peace. The official statistics may record 13 percent unemployment but it is clear that the true level of unemployment could be twice that and that there is a dangerously high level of young unemployed. Unless the authorities can offer the prospect of gainful employment to these people, we could easily face radicalization in a region characterized by potentially unstable politics. (I will probably make the same observation in the forthcoming Iranian discussion).

The basic strategy of fiscal restraint, privatization to promote both efficiency, competition, and a reduced debt burden is undoubtedly the correct one. There is good scope for the continued expansion of light manufacturing and, if genuine peace could be secured in the region, tourism has major potential.

Staff, however, see the rise in the real exchange rate as a source of concern, which may hinder significantly faster growth. They seem attracted to a flexible exchange rate but perhaps not yet. This is clearly a finely balance argument which presents me with some difficulty. Monetary policy is essentially about providing a stable financial environment, with low inflation and relatively low interest rates. The present policy has clearly been successful in this regard and the onus is on those who want a change to sell its inherent merits. I certainly do not think the Jordanians (or any other country) should target the real exchange rate and it is not clear to me what the alternative nominal anchor would be in a country like Jordan. If, for sake of argument, they were to target inflation-at say the present level—would interest rates be any lower? Could we be confident that a lower nominal exchange rate would deliver a lower real exchange rate. I would fear that a step away from the present stable regime for a country as small and vulnerable as Jordan would be simply too risky.

Moreover, I do not think we can hedge our bets on this, i.e., move in due course to a flexible rate. If the exchange rate regime needs changed, it both needs changed now and now is a good opportunity to do so: if the authorities remain firmly convinced of the benefits of the present regime, we should not try to create uncertainty about it.

It is interesting that exports have performed so well in spite of a rising real exchange rate. Perhaps this reflects the essentially more competitive nature of the growth industries in Jordan-they are not so exchange rate sensitive: perhaps also it reflects strong income growth in neighboring oil producing markets—the income effects are outweighing the price effects. Also, I have always been of the view that well-run companies can cope reasonably well with significant exchange-rate movements if these occur over a reasonable time period and at a time when wage and interest rate costs are reasonably stable.

There is a strong emphasis on reform of the pension system for public employees as a means to maintain fiscal control. I just wonder, however, can pension reform now have a significant fiscal impact within a few years. I would think that pension liabilities to public servants at or nearing retirement are as much a liability as government external debt nearing maturity—you cannot just renege on them or arbitrarily chop benefits. People must be given some possibility of making alternative arrangements to provide for their old age. To me the benefits of pension reform are a much longer-term issue. Of course, the only real answer to the pensions issue—as to the unemployment issue—is a prolonged period of sustained growth. Regardless of the institutional arrangements, future pensions can only be paid from future income. Purely as a practical issue, if it proved so difficult to bring into effect quite modest price increases in kerosene, is major pension reform politically feasible.

On one issue I want to express strong support for staff. The idea of placing privatization receipts in a privately managed fund which would invest in Jordanian enterprises is illogical and dangerous. First of all there remains a compelling case to continue to use privatization receipts to pay off debt. Secondly, if the debt level were to drop to very low levels and there were funds to be managed, they should be invested externally. This is essential for risk management purposes but more importantly, if they were invested in Jordanian companies, the Government would have gone through the painful, expensive and difficult process of privatization so that it could effectively take much of the Jordanian economy back into public ownership. To me this is illogical.

On a minor point relating to the safeguards assessment, I note that the staff has recommended that the CBJ establish a policy of periodic rotation of the external audit firm. Is this just a general principle which central banks across the world apply? Does the Fund itself do this type of thing? Is there any reason to doubt the present auditors? If not, I think we are in danger of becoming too intrusive.

I wish the Jordanian authorities every success in their continuing efforts.

Mr. Quarles made the following statement:

We support completion of the review and generally concur with staff's assessment, but would like to emphasize a few areas where more effort will be needed to realize the goals of this program.

Fiscal Policy

The authorities' fiscal effort fell well short of 2000 program targets, but their goals for fiscal consolidation and debt reduction remain within reach thanks to broadly prudent management of large privatization receipts and other exceptional inflows. Even so, we agree with others who have pointed out that going forward, the authorities should avoid over-reliance on transitory flows like these to counteract problems with policy implementation.

Targeting a 2 percent GDP improvement in the 2001 fiscal deficit before grants looks ambitious at first glance, but there is little leeway for the authorities to do otherwise, given the extent to which last year's deficit target was exceeded. This relatively large adjustment is essential just to get back on the path of fiscal consolidation mapped out under the program.

Going forward, risks to the fiscal program are clear, particularly from declining inflows of exceptional resources and possible shortfalls in non-tax revenues. We note that the 2001 nontax revenue target is quite close to the level projected but not achieved in 2000, and would appreciate clarification on why that target will prove more attainable this year.

In the event that these or other revenues are not fully realized again in 2001, we encourage the authorities to strengthen fiscal adjustment, rather than drawing on privatization or other exceptional resources to finance a higher deficit.

Monetary Policy

Although the CBJ's conduct of monetary policy has been strong, we note staff's concerns regarding the possible erosion of competitiveness. Here we agree with Messrs. Callaghan and Cho that real appreciation in the context of the peg may be constraining export growth from rising enough to achieve higher economic and employment growth and ensure a sustainable external position. Thus, we would also urge the authorities to consider a more flexible exchange rate regime, as well as the benefits of making this transition from a position of strength and stability, rather than at a time when the peg has come under acute pressure.

Structural Reforms

Jordan has made great strides in a number of areas, including fiscal structural reform, privatization, trade liberalization, and improvements in public debt management, and the authorities have indicated their commitment to further reduce structural distortions in the economy and improve the business environment.

The privatization program has yielded significant results, but we would urge restraint in channeling privatization proceeds away from debt reduction and into development spending. If proceeds are used on development projects, operations should be subject to a high standard of transparency and expected development impact. We also share staff's concerns about plans to place privatization proceeds with a privately managed investment fund.

Turning to other key structural issues, we note that reform of the petroleum pricing system is identified along with pension reform in paragraph 23 as "the main focus" of the structural agenda in the 2001 program, but is no longer subject to conditionality under the arrangement.

Given the budget's demonstrated vulnerability to oil price fluctuations under the current ad hoc system, we view this as a substantial weakening of critical structural conditionality, and would appreciate some explanation for why it was dropped.

Data Quality

Jordan's efforts to improve the availability and reliability of official statistics have been notable. We urge the authorities to continue making productive use of IMF technical assistance in this area, and welcome their decision to undertake a data ROSC.

Mr. Collins made the following statement:

The authorities deserve commendation for their continued commitment to reform. There has been significant progress in a number of areas. In particular, the successful introduction of a VAT in early 2001 and the decline in the public debt-to-GDP ratio are remarkable, as these were areas of concern in the last review.

On the other hand, the fiscal deficit has significantly exceeded the program target for 2000, which was already slightly higher than the actual deficit in 1999. While the deficit in the overall balance after grants has been obviously much lower, it is still nearly double the program target, and it represents a considerable deterioration from the corresponding 1999 figure. I am pleased to see that the program target for this year is considerably more ambitious, and I hope that the authorities can achieve it. However, as I said in the previous review, Jordan should aim at reducing its reliance on grants over time.

On structural reform, the authorities should make further progress in reforming the pension system and in widening the tax base. While I welcome the successful start of the privatization process, I encourage the authorities to make further efforts in this area, and I share the staff's concerns about the possibility that new institutional arrangements for privatization proceeds could facilitate extrabudgetary expenditures. I also encourage the authorities to continue their moves toward aligning the domestic price of petroleum more closely with world prices. In this context, it is also worth mentioning that the reliance on cheap imports of Iraqi oil implies risks for the fiscal and balance of payments positions, as this source of oil might not have continuity in the future. This highlights the need to eliminate domestic price subsidies as soon as possible.

Unemployment remains a major challenge. We share the views expressed in Box 1 that actual unemployment is considerably higher than measured unemployment. With more women and young people entering the labor force—which is expected to expand by 40 percent by 2010—this problem is likely to intensify. More generally, we remain concerned, like Mr. Charleton and Mr. Quarles, about the quality and reliability of statistics, as this means that the relatively upbeat official figures might be misleading. It is our understanding, for example, that business confidence is extraordinarily low. In this context, I welcome the authorities' agreement to take part in a data ROSC.

On the exchange rate, I can understand the authorities' reasons to maintain the pegged exchange rate arrangement. With the dollar more likely to fall than rise in the forthcoming period, they may be justified in thinking that this would not be a sensible time to move to a flexible exchange rate. Like many other Directors, I can go along with the authorities' decision to maintain the peg. However, the authorities should be aware of the advantages of abandoning the peg at a time of strength, rather than being forced to abandon the peg by market forces, as the peg would certainly loose its benefits at some point in the future. Therefore, the authorities should remain vigilant on this front.

Finally, the risks to regional economic stability arising from the situation in Lebanon, and the obvious political and security risks linked to the uneven pace of the Middle East peace process are inevitably having an effect on Jordan. These risks intensify the need for extreme prudence in macroeconomic management and for perseverance with structural reform. We wish the authorities well in this difficult task.

Mr. Jacoby made the following statement:

Prudent macroeconomic management and sustained structural reforms have enabled Jordan's economy to continue its good performance. And despite the recent failure to meet certain fiscal and structural targets, there can be no doubt of the authorities' determination to implement the policies needed to bring sustainable high growth in the medium term. It is a pleasure to join the staff and other Directors in commending the authorities' achievements during the second year of the program supported by the extended arrangement.

Be that as it may, however, the authorities must avoid a repetition of last year's fiscal slippage if they seriously hope to succeed in consolidating the public finances in the medium term. In this connection, completion of the structural fiscal reforms will be absolutely essential for limiting the growth of expenditures. Even with a sustained reduction of the fiscal deficit, it is hard to see how the authorities can manage, within the next five years, to bring the ratio of total government and government-guaranteed debt-to-GDP down to 50 percent from its current level of 80 percent. And of course the goal of successful fiscal consolidation will also require considerable enhancement of revenues. It is especially important for the authorities to implement the reforms needed to bring domestic petroleum prices into better alignment with world prices.

As to monetary policy, it is plain to see that the peg has made an important contribution to Jordan's present macroeconomic stability. Any attempt to move away from the peg must be carefully pondered. In the absence of an exchange rate peg, the authorities will have to find an alternative nominal anchor and adopt very strict fiscal rules if they are to maintain a credible commitment to low inflation. And, while I do agree with the staff that the strong dollar may have hampered export-led growth and private investment in Jordan, it also kept foreign-denominated debt from going haywire. We must remember that Jordan's external debt was still equivalent to 81 percent of GDP in 2000.

With these remarks, I support the proposed decisions and wish the authorities all the best in their future endeavors.

Mr. Vogel made the following statement:

At this stage of the discussion, allow me to express agreement with the thrust of the staff appraisal and only make a few specific comments. First of all, we welcome the advances made in Jordan's economic structural reforms and reflected in the macroeconomic performance of 2000. For the first time in several years, per capita income increased, CPI inflation was below the programmed level, and net government debt fell as a consequence of large privatization receipts. However, still there are important risks for macroeconomic stability particularly related to the high fiscal deficit that exceeded the programmed level and the unfavorable labor market developments.

As shown in Box 1 of the staff report, the unemployment rate has stayed high despite the low rate of labor market participation. The unemployed, the contingent of discouraged workers who have left the labor force and those that are underemployed comprise almost one-third of the active population. We would like to hear from staff on the strategies that are being considered by the government to confront the difficulties in the labor market and their social implications.

The fiscal is an issue that needs to be addressed promptly. The offsetting of higher current budgetary expenditure by lower capital spending may also have serious structural consequences and undermine future growth possibilities. In this regard, we welcome the program that the authorities have initiated to modernize the public sector, in order to improve the efficiency of budgetary expenditure. As the staff report underlines, revenue shortfalls have influenced the deteriorated fiscal performance. In this sense, the introduction of the VAT, and the requested FAD technical assistance are welcomed steps in order to implement structural reforms in tax administration in line with the international best practices.

> On monetary and exchange rate policy, it seems evident that the current exchange regime has made a significant contribution to monetary policy credibility and economic stability. However, the need to periodically raise interest rates, as well as the continuous real appreciation of the real exchange rate, appear to impose restrictions on the expansion of economic activity. In this regard, we agree with the staff to urge the authorities to consider the cost and benefits that a more flexible exchange regime could bring to the economy.
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> As Mr. Shaalan notes in his helpful preliminary statement, substantial progress has been made in the privatization agenda this last two years. However, we share Mr. Portugal and Mr. Rambarran's views on the need that a privately managed fund will be managed efficiently and on a purely commercial basis and will avoid giving rise to extra budgetary expenditure. According to other structural reforms, we urge the authorities to accelerate the reform of the pension system, with rapidly growing contingent liabilities and that could become a heavy burden in the future.
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> With these remarks, we support the proposed decision and wish the authorities every success in their future endeavors.

The staff representative from the Middle Eastern Department (Mr. Furtado) observed that fiscal adjustment was the key element on the macroeconomic side of the program. The experience in the first two years of the Extended Arrangement had been positive in the areas of tax revenues and expenditures. While there were concerns that shortfalls in nontax revenues experienced in this period might recur in 2001, the staff's projections envisaged a fairly solid outlook for nontax revenues. Positive factors influencing nontax revenues in 2001 included gasoline, diesel and butane price increases that would raise the oil surplus, and larger transfers of profits from the central bank, including profits accrued in 2000.

Exchange rate policy was another important aspect of the macroeconomic program, the staff representative continued. The staff supported the authorities' decision to maintain in the 2001 program their current approach to exchange rate policy, as manufactured exports appeared to be performing well despite the appreciation of the real effective exchange rate. Nevertheless, the authorities should be aware that large volumes of capital inflows had played a role in maintaining a comfortable level of reserves without the need for higher interest rates. Maintenance of the exchange rate peg might place an excessively heavy burden on interest rates under different circumstances. In this context, the authorities had been cautioned of the need to consider the option of moving toward a more flexible exchange rate from the current position of strength.

Turning to the structural conditionality in the Fund-supported program, this had been sharply streamlined in the context of the current review, the staff representative explained. One of the reasons for the streamlined conditionality had been the strong commitment shown by the authorities to the ongoing privatization program. The authorities were currently embarking on a key element of this program, which was the privatization of the power sector.

In this context, it had not been considered appropriate to maintain specific conditionality on privatization in the Fund-supported program. The delay in the completion of the current review had also reduced the need for structural conditionality, as several measures that would have been included as conditions in the program had already been implemented since April 2001, when the Board meeting on the third review of the program should have originally taken place. In particular, the enactment of the important laws on income tax and public debt, which had been approved during spring in an extraordinary session of parliament, would have certainly been included as structural conditions in the program.

The only remaining structural measures that should be implemented during fiscal year 2001 were the introduction of a petroleum pricing mechanism and pension reform, the staff representative clarified. However, only the pension reform had been established as a condition in the program. The use of a benchmark, rather than a criterion, to track the completion of this measure would allow the authorities greater flexibility in the design of the reform. In addition, having a benchmark on pension reform would maintain the focus on the need to effectively and timely implement that reform, while at the same time allowing the Fund greater scope in the qualitative assessment of the progress made by the time of the following review. Such considerations notwithstanding, the commitment to introduce a petroleum pricing system and to reform the pension system had been reflected in the memorandum on economic policies, and those areas would feature prominently in the upcoming program review, which had been scheduled for the fall of 2001.

In the area of financial sector reform, the loan classification criteria had been first tightened from 180 days to 150 days, and later to 120 days, the staff representative confirmed. However, the amount of provisions as a percentage of classified loans had fallen because certain types of loans included in the set of classified loans after the tightening of classification criteria were subject to lower provisioning rates. The central bank had assured the staff that all banks were meeting their provisioning requirements.

Regarding the activities of the central bank, the Fund’s Treasurer’s Department had recommended during the safeguard assessment that the firm auditing the central bank should change after some time, the staff representative explained. That was a general recommendation in safeguards assessments, which was particularly relevant in Jordan’s case because the current auditor had been providing that service for a long time, and an excessively close relationship with a long-time auditor should be avoided. The central bank had pointed out that the choice of auditor was the responsibility of the central government.

Stronger economic growth would be the main requirement to reduce the currently high level of unemployment, the staff representative observed. There were no major rigidities in the labor market, as the level of unionization was low and welfare programs were not prevalent. Therefore, labor market reform was not a requirement to enable a reduction in unemployment. Population dynamics were not as severe in Jordan as in other areas in the region. A study carried out in the West Bank and Gaza showed that annual growth rates of 6 percent would be sufficient to maintain the unemployment rate stable. In Jordan, where population growth was slower, the similar GDP growth envisaged for the next few years would make a significant contribution to reduce the unemployment rate.

Mr. Quarles was puzzled by the different treatment in program conditionality of the need to introduce a petroleum pricing system and to reform the pension system. It would appear sensible to include the petroleum pricing system in program conditionality as well as the pension reform, given that they had both been described as priorities in structural reform.

The staff representative from the Middle Eastern Department (Mr. Furtado) explained that the issue of oil pricing had been extensively discussed with the authorities, both in terms of the initial adjustment needed in the price and of the policy that should follow that initial adjustment. In fact, the discussions on the initial adjustment had been the main cause for the delay in the Board's considerations of the current review. The authorities had considered that it would be difficult to adopt a rule institutionalizing a close link between domestic prices and import prices at the same time as they were implementing a large initial price increase. In addition, the establishment of a clear-cut mechanism would remove the flexibility currently available to raise prices when costs increased, but to refrain from lowering them automatically when costs decreased. The authorities had opted to have a quarterly review of prices with the aim of protecting targeted oil revenues under the program, and to postpone the adoption of a more specific mechanism for the determination of oil prices.

Mr. Shaalan made the following concluding remarks:

> I would like to thank my colleagues for their constructive and critical views which will be reflected in my report to the authorities. I would also like to note the words of encouragement regarding Jordan's performance. I have a few comments on questions that were raised on fiscal issues, exchange rate, and interest rate issues, as well as on unemployment.
>
> The reasons for the shortfall in nontax revenues in 2000 were for the most part outside the control of the authorities. Projected royalties on phosphates did not materialize because of weak phosphate prices. The oil fund surplus was smaller than projected by 3 percentage points of GDP as a result of the increase in prices in imports from Iraq during the year. Expenditures were held down to prudent levels as required in the program. Nevertheless, certain expenditures related to development projects had increased under existing agreements with donors. If I am not mistaken, Germany grants debt reductions equivalent to twice the amount spent on certain development projects.
>
> Regarding the use of privatization proceeds to reduce public debt, particularly when this is high, the Fund has no standard practice in this area. Some countries have opted to include privatization proceeds above the line, whereas other countries account for them below the line. In the case of Jordan, the proportion of privatization receipts included above the line is rather limited, around 5 percent of the total. The other 95 percent has been largely used to reduce public sector debt. Debt has indeed fallen dramatically, and it is projected to continue to decline rapidly, allowing greater flexibility to

budget formulation and implementation. A lower stock of debt also releases resources from interest payments that can be used for other purposes.

It is widely recognized that Jordan has made significant progress with structural reform, even if, as one Director has remarked, the record in this area is not perfect. Of course, I would like to know which country has a perfect record in the area of structural reforms.

On the exchange rate, I will not attempt to answer the question of whether this is over or under appreciated. Our record of ascertaining whether rates are over or under appreciated is abysmal. All we know in the case of Jordan is that, despite the difficulties in the West Bank and Gaza, the weak prices of phosphates, and the bleak outlook on tourism, manufactured exports have risen by 23 percent, a very high rate by any standard. Incidentally, in the tourist industry, tourists from the region have been recently replacing tourists from outside the region, so the tourist season is much better than had been anticipated.

Regarding Mr. Quarles's comment that now would be an opportune time to move toward a more flexible exchange rate regime, I agree that these appear to be good times if we look at the economic indicators. However, it would not be advisable to make such a move under the existing political uncertainties in the region.

Compensation payments by the UN were mentioned in connection with exchange rates and the balance of payments. I would like to clarify that these compensation payments have nothing to do with manufactured exports rising by 23 percent, although they obviously have something to do with the balance of payments. We need to make a distinction between these two considerations.

On interest rates, some Directors have indicated in their preliminary statements that these were probably excessively high. They currently stand at about 5 percent, which does not seem to me to be excessively high under current circumstances.

The official figures on unemployment point to a 12 to 13 percent rate. Informal or market estimates are around 20 percent. However, one should not take these figures at their face value, as they include a lot of people who returned after the Gulf War to Jordan who are currently not working. They possibly also contain some people who have returned from the war zones of Gaza and the West Bank.

An interesting remark was made by another Director regarding the low level of confidence in spite of the good economic indicators. I do not find this surprising in a context of regional turmoil. The surprising thing is that in spite of the difficulties in the region, the good indicators are continuing, and are projected by the staff to continue.

The Acting Chairman (Mr. Fischer), in response to Mr. Shaalan's comment regarding the need to refrain from moving to a more flexible exchange rate under existing political uncertainties in the region, observed that in his long experience in discussions with national authorities on the best time to abandon exchange rate pegs, national authorities had always found a good reason for delay.

Mr. Shaalan considered that if political conditions in the region were more peaceful, and under current economic conditions, it would have been a good time to move toward a more flexible exchange rate.

The Acting Chairman (Mr. Fischer) recalled that, while conditions had been much more peaceful nine months earlier, he had not detected any enthusiasm in the country for the option of abandoning the peg.

Mr. Al-Turki stated that it would certainly be inappropriate to abandon the peg under current circumstances.

The Acting Chairman (Mr. Fischer) concluded that the Board would return to the issue in the future. One of the weaknesses of pegged exchange rates was that countries never abandoned them when economic conditions were favorable despite the Fund's wise advice to do so.

The Acting Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They noted that Jordan's economic performance recorded important successes during the second year of the program supported by the current extended arrangement. Real growth has accelerated, inflation remains low, the debt ratio has fallen appreciably, international reserves have stabilized at a comfortable level, and interest rates are falling. Directors commended the authorities for implementing wide-ranging structural reforms, including the introduction of a VAT, trade liberalization, financial sector modernization, and the pursuit of the privatization program. Directors attached high priority to strengthening the efforts to reduce the fiscal deficit, which had widened in 2000 as certain revenue items did not reach their targeted levels.
>
> Directors noted that certain exceptional receipts, notably privatization revenues and the inflow of UN compensation payments, which cushioned the effects of the fiscal slippage in 2000, cannot be expected to be sustained indefinitely. They therefore emphasized the need for a sustained reduction in the fiscal deficit over the medium term to reduce Jordan's reliance on significant levels of foreign assistance and vulnerability to external shocks, and also to release resources for private sector investment.

Against this backdrop, Directors viewed the targeted reduction in the fiscal deficit in 2001 as reasonably ambitious. They noted that achieving this target would require strong efforts on both the revenue and expenditure sides. The recent increase in the domestic prices of some petroleum products was welcome, but Directors stressed the need for continued vigilance through strict adherence to a prudent expenditure plan, early identification of revenue shortfalls, and the rapid implementation of offsetting measures if needed.

Looking ahead, Directors agreed that lasting fiscal consolidation would require important structural changes. On the expenditure side, a central element will be the reform of the public pension system, which has been growing rapidly and threatens to become a major burden on the budget. Directors urged the authorities to complete the technical work to prepare this reform as soon as possible, and build a domestic consensus to implement it. They also looked forward to initiatives to rationalize the public administration and improve the delivery of government services. On the revenue side, the authorities should continue efforts to broaden the tax base and adjust petroleum product prices regularly.

Directors commended the authorities on their prudent conduct of monetary and exchange rate policy over the past several years. These policies have imparted considerable credibility to the current pegged exchange rates regime, and have led to increasing demand for the dinar, and a decline in interest rates. While acknowledging Jordan's recent favorable export performance, some Directors considered that the significant appreciation of the real effective exchange rate in recent years may have hampered export growth and diversification, and private investment. However, most Executive Directors cautioned against any change in the exchange rate system, noting that it had served Jordan well.

Directors welcomed the authorities' firm commitment to protect social spending under the current program, but noted that reducing Jordan's high unemployment rate would require continued broad-based reforms to enhance competitiveness and improve labor market efficiency. Directors cautioned that the planned investment fund, which would invest a portion of private proceeds in Jordanian ventures, should be managed transparently and on a strictly commercial basis.

Directors commended the progress made under the program in improving Jordan's statistical base. They welcomed the authorities' decision to volunteer for a data ROSC exercise and to pursue with Fund technical assistance further enhancements to the fiscal statistics in the period ahead.

The Executive Board took the following decision:

Jordan has consulted with the Fund in accordance with paragraph 3(f) of the Extended Arrangement for Jordan (EBS/99/51, Sup. 3, 4/28/99) and paragraph 29 of the memorandum attached to the letter of the Minister of Finance and the Governor of the Central Bank of Jordan, dated July 4, 2000.

The letter of the Minister of Finance and the Governor of the Central Bank of Jordan, dated August 7, 2001, together with its attached Memorandum of Economic and Financial Policies ("MEFP") and Technical Memorandum of Understanding ("TMU"), shall be attached to the Extended Arrangement, and the letter, dated March 31, 1999, as modified, shall be read as supplemented and modified by the letter dated August 7, 2001, the MEFP, and the TMU.

Accordingly, the extended arrangement shall be modified in the following manner.

(a) Paragraph 2 shall be deleted and replaced with the following:

"Purchases under this Extended Arrangement shall not without the consent of the Fund exceed the equivalent of SDR 10.66 million until August 15, 1999, the equivalent of SDR 21.32 million until July 15, 2000, the equivalent of SDR 36.54 million until November 15, 2000, the equivalent of SDR 51.76 million until February 15, 2001, the equivalent of SDR 66.99 million until November 15, 2001, and the equivalent of SDR 97.43 million until February 15, 2002."

(b) Paragraph 3(a)(ii) shall be deleted and replaced with "the limit on the overall deficit before grants of the general budgetary government, or", and paragraph 3(a)(vii) shall be deleted from the extended arrangement.

(c) Paragraph 3(f) shall be deleted and replaced with the following:

"after August 14, 1999, July 14, 2000, November 14, 2000, November 14, 2001, and February 14, 2002 until the respective reviews contemplated in the memoranda attached to the letters dated March 31, 1999 and July 4, 2000, and in paragraphs 20 and 21 of the MEFP are completed; or".

(d) The performance criteria specified in paragraphs 3(a)(i) through 3(a)(vi) for September 30, 2001 and December 31, 2001 shall be as specified in Table 1 of the MEFP and in the TMU.

The Fund decides that the third review contemplated in paragraph 3(f) of the Extended Arrangement is completed and that Jordan may make purchases under the arrangement notwithstanding the nonobservance of the end-December 2000 performance criteria on net bank claims on the general budgetary government and on the submission of amendments to the income tax law specified in paragraphs 3(a)(ii) and 3(ee) of the arrangement, on the condition that the information provided by Jordan on performance under these criteria is accurate. (EBS/01/136, 8/13/01)

Decision No. 12554-(01/85), adopted
August 29, 2001

## 2. MALAYSIA—2001 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 2001 Article IV consultation with Malaysia (SM/01/242, 8/2/01). They also had before them a paper on selected issues in Malaysia (SM/01/256, 8/15/01), and a statistical appendix (SM/01/256, Sup. 1, 8/15/01).

The staff representative from the Asia and Pacific Department made the following statement:

The following information, which does not change the thrust of the staff appraisal has become available since the staff report was issued. Economic activity continued to weaken, in line with deteriorating global developments and prospects. This situation intensifies the policy dilemma highlighted in the report that is associated with the authorities' desire to maintain the exchange rate peg and implement expansionary policies, and has been a subject of recent comments by market participants.

Real GDP growth in the second quarter of 2001 slowed further to ½ percent (year-to-year), with manufacturing production falling by almost 7 percent; the unemployment rate rose to about 4 percent by June. The impact of adverse external conditions has been more severe than anticipated, and is expected to persist. Consumer and business confidence continued to deteriorate, resulting in weak retail sales, high inventories, and slow investment, which in turn led to a further decline in production. Unless external demand (mainly driven by developments in the U.S. economy) recovers soon, the staff's projection of output growth for the year (2 percent) could prove to be optimistic, notwithstanding fiscal measures aimed at stimulating domestic demand.

External trade performance was also weak in the second quarter, but gross international reserves increased slightly. In June, exports fell by 13 ½ percent (year-to-year), following a 7 ¼ percent decline in May and continuing a downward trend of the past four months; imports fell by 10 ½ percent in each of the past three months compared with the corresponding period of last year, reflecting weak domestic demand and a decline in imports of raw materials for electronics exports. While the trade account remained in small surplus, net capital outflows eased following the stabilization of the yen and other regional currencies and the narrowing differentials between the U.S. and Malaysian interest rates. FDI inflows were relatively robust, and net portfolio outflows diminished noticeably. Gross official reserves as of mid-August 2001 stood at $27.5 billion, up from $27.1 billion in mid-July, providing adequate coverage for imports and short-term external liabilities.

The Kuala Lumpur Stock Exchange (KLSE) fared well compared with those in neighboring countries despite the weak performance of the Malaysian economy. The KLSE index rebounded by more than 10 percent in June/July, making up for much of the losses earlier this year. Improved investor sentiment and a revival of portfolio investment could be due, in part, to the recent government actions to expedite corporate restructuring (see below). Sovereign bond spreads remained stable.

The implementation of the government's fiscal stimulus package was slow in the first half of 2001. The budget recorded a small deficit of only 0.1 percent of GDP (compared with the full-year target of 5.9 percent of GDP). The original 2001 budget was carried out broadly at the same pace as last year, but expenditure of the additional RM 3 billion under the supplementary budget has been delayed. Although much of the planned spending is expected to be executed during the remainder of the year and the deficit for 2001 is likely to be substantial, the staff believes that the size of the fiscal stimulus could be somewhat smaller than in the budget, and thus its impact may not be fully realized during 2001.

Monetary policy continued to be accommodative, while indicators of financial soundness worsened somewhat. Real interest rates remained low and there was ample liquidity in the banking system, but credit expansion to the private sector was weaker than anticipated because banks were reluctant to extend loans in light of the underlying risks of rising nonperforming loans (NPLs). The gross NPL ratio (based on three-month definition) increased to 16.7 percent in May, up from 15.3 percent at end-2000 (the corresponding net NPL ratios were 10.9 percent and 9.6 percent, respectively). In response, Bank Negara Malaysia has stepped up the monitoring of provisioning requirements.

Further progress has been made in the bank merger program. Two more banks have concluded agreements; thus, a total of 52 banks have now been merged into ten banking groups, accounting for about 99 percent of the domestic banking system's total assets, and the remaining two banks are expected to finalize the process by end-2001. Additionally, most of the merged banks have completed business and system integration, as well as staff retrenchment.

The government has also taken steps to address corporate governance issues related to some high profile cases and to encourage mergers and acquisitions by smaller corporations. The ongoing discussions for the government takeover of Renong and United Engineering Malaysia have been viewed favorably by the market, which interpreted this action as evidence of the government's accelerated efforts in operational and debt restructuring. However, the near-term outlook for corporate financial positions remains vulnerable to the economic slowdown. To address this situation, the Corporate Debt Restructuring Committee (CDRC) announced, in early August, new initiatives to intensify corporate restructuring efforts. Measures include: (1) securing commitments from both borrowers and creditors to formulate a joint proposal within 3–4 months for both operational, as well as debt, restructuring; and (2) strengthening disclosure and reporting standards, with the issuance to the public of quarterly updates on CDRC's progress and more comprehensive reports on corporate borrowers currently under CDRC.

Mr. Low and Ms. Phang submitted the following statement:

Our authorities appreciate the opportunity to engage in wide-ranging discussions with mission staff on the macroeconomic outlook and issues that are pertinent to Malaysia. While they agree that the staff report has provided a broadly balanced assessment of the Malaysian economy, they saw the need to clarify certain staff observations and views that could otherwise lead the reader to draw inaccurate conclusions on the economic situation in Malaysia or the policy stance of the Malaysian authorities.

As highlighted in the staff report, the Malaysian economy expanded strongly in 2000, underpinned by strong export growth and higher domestic expenditure. Growth was broad-based across both demand and supply, with real GDP expanding by 8.3 percent.

As in the case of most regional economies, Malaysia began to feel the impact of the slowdown in the United States and Japan in the first quarter of 2001 when real GDP increased at a slower rate of 3.1 percent (4Q 2000: 6.3percent). Growth in the first quarter of 2001, amidst slower growth in exports, was supported by higher Government spending and continued growth in gross capital formation. Growth in the second quarter slowed down to 0.5 percent (year-on-year) and 1.1 percent from the preceding quarter, as the global economic slowdown became more severe than expected. The downturn in the second quarter was mainly in the electronics industry. Activity in domestic demand-oriented sectors registered relatively strong positive growth, as the effects of low interest rates and the fiscal stimulus filtered into the domestic economy.

Notwithstanding the slower second quarter growth, Malaysia's macroeconomic fundamentals remain strong. Inflation remains low at

1.5 percent in the first seven months of 2001. The current account remains in surplus and foreign direct investment inflows have been sustained. External debt is low at 49.5 percent of GNP as at end-June 2001 with short-term debt accounting for 11 percent of total external debt and debt service ratio being equivalent to 4.8 percent of export earnings. The level of reserves remains comfortable at US$27.4 billion as at 15 August 2001 and has returned to an upward trend. This level of reserves is adequate to cover 5.8 times the short-term external debt (or 3.2 times if debt due in the next 12 months were included), and to finance about 4.1 months of retained imports. Meanwhile, following the accelerated pace of restructuring, the banking sector has remained resilient with risk weighted capital ratio (RWCR) of 12.4 percent in June and net NPL of 7.8 percent in May.

The strong fundamentals have accorded Malaysia the policy flexibility to implement preemptive pro-growth policies to strengthen domestic demand to mitigate the adverse impact of the global slowdown. Preemptive measures announced on March 27 included an additional fiscal stimulus of RM3 billion, a reduction in employees' share of provident fund contribution on a voluntary basis and liberalization of regulations for foreign property buyers. In addition, Malaysia's diversified economic base has helped to cushion the impact of the slowdown in external demand. In the electronics industry, manufacturers have further improved inventory management. The duration of the current inventory adjustment is now shorter and Malaysian manufacturers are able to accelerate production once demand recovers. The electronics manufacturers have also undertaken several proactive strategies to enhance productivity and improve cost effectiveness to protect profit margins.

Looking ahead, the Malaysian economy will continue to be subject to the vagaries of the global business cycle as trade accounts for more than 200 percent of GDP. While the slowdown in growth is a matter of concern, it is important to recognise that the thrust of macroeconomic policy and Malaysia's strong underlying economic fundamentals remain on track for sustainable long-term growth. Our authorities will continue to emphasise growth strategies that will enhance the contribution of domestic demand to broaden the sources of growth and develop a more diversified and resilient economy. The conduct of macroeconomic policy will remain focused on ensuring that no imbalances arise. Together with stronger corporate and financial sector reforms, our authorities are confident that a strong foundation is in place for the Malaysian economy to respond promptly and effectively to the upturn in the global business cycle. It is also important to note that the banking system has now strengthened. The capital base of the banking sector is now stronger at RWCR of 12.4 percent, while the core capital ratio is 10.5 percent. With an additional "cushion" of more than RM18 billion above the international benchmark of a RWCR of 8 percent, the banking sector has adequate capital to absorb any rise in NPLs arising from the economic slowdown.

While there is broad general agreement on most of the policy issues, there appears to be a difference of views on the exchange rate policy.

Contrary to staff views, the Malaysian authorities consider the present macroeconomic policy mix of a pegged exchange rate regime, fiscal expansion and low interest rates as consistent, especially in view of the significance of external developments on the domestic economy in the current environment. Following lengthy discussions with staff on the practical implementation issues or “mechanics” of macroeconomic management in Malaysia, the authorities are concerned that in their diagnosis, the staff still has difficulty in grasping the point that the policy mix for an individual country should take into account its specific circumstances. The authorities still see the staff drawing conclusions that are based on the standard approach of flexible exchange rates as the optimum arrangement for all countries at all times.

The staff’s repeated recommendations that Malaysia shift toward a flexible exchange rate regime go against the current accepted view in all surveillance fora (APEC, Manila Framework, ASEM, including the IMFC). At these fora, it has been acknowledged that no single exchange rate regime is suitable for all countries at all times. What is important is that the exchange rate regime is well supported by the economic and financial fundamentals.

Staff’s view of inconsistency based mainly on the CGER estimations can itself lead to inconsistent policy recommendations. Our authorities are all too familiar with the inherent shortcomings of CGER estimations. During the 2000 Article IV mission, the staff had urged for an upward revision of the peg as their CGER estimations indicated that the ringgit was substantially undervalued compared with our authorities’ assessment that the undervaluation was low and contained at the single-digit level. The actual outturn has proven the authorities right in not making any adjustment then. This year, the staff is inferring the opposite. The authorities’ assessment is that the exchange rate of ringgit at its current level, even if overvalued, is too small to warrant a change in the exchange rate.

The authorities strongly view that Malaysia’s fundamentals support the current fixed exchange rate at RM3.80 to the U.S. dollar. Specifically, that low inflation, a strong current account, strong reserves position, low external debt, a strong banking system, and a diversified economic structure with flexible market practices that can respond to changes in demand, all provide the fundamental support to the exchange rate. The staff should acknowledge that past failures of fixed exchange rates in many countries were not because of the regime but because these fundamentals were not present.

With trade at more than 200 percent of GDP, stability in the exchange rate is important. A stable exchange rate in itself is a powerful competitive tool. As a matter of policy, our authorities do not believe in using the exchange rate as a tool for gaining export competitiveness. The authorities view that competitiveness would be more sustainable if it were achieved through enhancing productivity and reducing the cost of doing business. In this regard, much work is already ongoing to ensure that Malaysia remains competitive by reducing the cost of doing business.

The authorities also maintain that policy decisions on the exchange rate should not be based on "knee-jerk" reactions to short-term changes in market perceptions that do not reflect any underlying shift in economic fundamentals. The recent pressures on the peg and the decline in BNM reserves in March–April 2001 were market responses to short-term developments in the region, some of which were political and country-specific. There was no change in economic fundamentals of regional economies. As such, it was right for Malaysia to absorb some temporary decline in reserves during this period. A change in the exchange rate would have been more destabilizing.

When the current environment is volatile and charged with uncertainty, and in view of the tendency for financial markets to overshoot, a shift to a flexible exchange rate regime would lead to a precipitous depreciation of the currency and introduce greater uncertainty and instability into domestic financial markets. Contrary to the staff's assumption, a weaker currency will not necessarily improve competitiveness nor increase the level of exports in view of the global slowdown in external demand. In fact, figure 2 in the report shows that the export performance of Malaysia is relatively better than most of the countries selected for the comparison even though these countries have adopted flexible exchange rate regimes and have experienced a depreciation in their currency. This has been due largely to the more diversified export base that has helped to moderate the impact of the downturn in the global electronics industry in Malaysia. Any competitive advantage derived from a depreciation of the exchange rate can only be expected to be temporary and would be offset by other implications of depreciation on the economy, such as the threat of higher inflation and increased import and external debt servicing costs.

Events since April 2001 have demonstrated that the authorities made the right choices in resisting pressures to change the exchange rate peg. As regional exchange rates stabilized/strengthened with the return of relative political stability, external reserves in Malaysia have reverted to a rising trend. The staff's recommendation is for Malaysia to move to a more flexible exchange rate regime "as soon as circumstances permit". Such policy changes cannot be based solely on hypothetical reasoning. Our authorities will continue to monitor closely a variety of indicators and continually review the risks and benefits of all available policy options in order to prepare for any eventuality.

Our authorities strongly disagree with the staff's recommendation that maintenance of the peg at this juncture would require preparedness to adjust other macroeconomic policies as warranted, including a tightening of interest rates. It is extremely disappointing for the staff to recommend that Malaysia should raise rates, even if higher rates "could lead to a negative cycle similar to the one that exacerbated the 1997-98 crisis" (paragraph 47 of staff report). Such a recommendation, especially in an environment of economic slowdown makes the authorities doubt whether staff has any understanding of the consistency of macroeconomic policies in Malaysia. Furthermore, interest rate differentials are narrowing as global interest rates are declining. As a result, Malaysia's reserves are now on a rising trend.

Similarly, the staff has misinterpreted the goal of monetary policy. In the staff report (paragraphs 10 and 53), it was suggested that "… the authorities have managed interest rate policy with the goal of balancing support for economic growth, promotion of domestic savings and maintenance of adequate profit margin for banks." Our authorities wish to reiterate that the main objective of monetary policy is to attain price stability. The current accommodative monetary policy is to support economic growth amid stable and low inflation given the unfavourable external environment. It has never been the intention of monetary policy to ensure adequate profit margins for banks and their shareholders. There is therefore some confusion here between policy objectives and the results of policies implemented. Other structural measures and initiatives have been taken to ensure the strength of the banking sector.

As pointed out in the staff report, our authorities intend to adopt more market-based instruments for liquidity management, including the recently reintroduced BNM bills. We are also pleased to report that substantial progress has been achieved in enhancing credit risk management in the banking sector. As part of the aim to infuse and diffuse the adoption of international best practices in credit risk management, BNM has developed a set of guidelines which banking institutions have begun to implement. In early 2001, the liquid asset requirement was removed and replaced by the prudential-based liquidity management framework that was adopted by all banking institutions. This would pave the way for the use of more market-based policy instruments.

With regard to the staff's views that banks should be able to set appropriate deposit and lending rates without governmental directives, our authorities wish to point out that the banking institutions are free to determine their deposit and lending rates. However, to minimize the incidence of excessive lending charges, BNM sets the maximum spread that the bank may charge above the base lending rate as well as the maximum base lending rate which banking institutions can quote to their customers. In its Financial Sector Master Plan, BNM intends to liberalize further the BLR and/or its eventual removal. This move will be implemented at a time and in a manner that is consistent with the development of the financial infrastructure as outlined in the Financial Sector Master Plan.

Our authorities note the staff's endorsement of the stance of Malaysia's fiscal policy and the deferment of fiscal consolidation in view of the need to avoid a sharp output slowdown in the face of deteriorating external demand. While the level of public debt to GDP and the Federal Government debt servicing has risen, it remains manageable. The bulk of the increase in expenditure was also due to implementation of the fiscal stimulus program to revitalize the economy over the medium term and it would not create risks for the economy. With pro-growth expenditure and a good revenue collection system, the authorities estimate that debt servicing will take a small share of total government expenditure (currently 17 percent). Meanwhile, the public enterprises' debt level will not impose a burden on the Government as borrowings were raised by corporations which have the capacity to generate future streams of income to service their debt.

On the issue of contingent liabilities arising from the possible acquisition of additional privatized projects, our authorities wish to clarify that any acquisition of privatized projects will be done on a selective approach, based on strategic and national interests. Such acquisitions will be implemented through the establishment of Special Purpose Vehicles (SPVs), with the cost of acquisition being funded via private debt instruments. Such acquisitions are not expected to increase the public sector debt but may have an impact on the budgetary allocation of the Federal Government if revenues derived from such projects are insufficient to service the restructured debt.

Most of the privatized projects facing financial difficulties were funded by conventional short/medium term loans. The long gestation periods of infrastructure projects resulted in a mismatch between the revenue and debt repayments. The funding mechanism of the SPVs, therefore, takes advantage of the increasingly more developed Malaysian capital market that allows for longer term financing which augurs well for infrastructure projects with long gestation periods. In addition, the acquired privatized projects will not only undergo a financial restructuring but operational restructuring is a key element to ensure continued viability and efficiency of the projects.

Crisis-related restructuring has moved to an advanced stage with the Asset Management Company, Danaharta, focusing only on asset management. As of 30 June, Danaharta has restructured or disposed of loans and assets with a gross value of RM40.9 billion with an average recovery rate of 66 percent. Danaharta continues to accelerate the corporate restructuring exercise.

The longer-term programme of consolidation of the banking sector has been completed and the focus now is on building and strengthening domestic capacity. Further consolidation of the domestic banking system would be determined by market conditions while BNM has continuously upgraded its supervisory practices so as to achieve fully effective, risk-based supervision.

The accelerated pace of restructuring in the banking sector has contributed toward the strengthening of the financial system. This has provided BNM the flexibility to bring forward one aspect of the plan to allow foreign-owned banks to offer interactive internet banking as early as January 2002 rather than in Phase 2 of the plan. Bringing forward other aspects of the plan can also be considered, with due consideration being given to the importance of proper sequencing of reforms and the appropriate timing for success.

On the issue of guarantees of deposits, the authorities recognize the moral hazard of blanket guarantees on banking institutions. There is already a plan to replace the guarantees with a deposit insurance scheme under the Financial Sector Master Plan. In the meantime, adequate safeguard measures are in place to minimize the moral hazard situation, including more intensive supervision and stronger corporate governance. When it is deemed that sufficient progress has been made in the financial reform process, Malaysia will be pleased to participate in the Financial Sector Assessment Programme.

Considerable progress has been made on corporate debt restructuring. In early August, the Corporate Debt Restructuring Committee (CDRC) was reorganized with the appointment of a new chairman. This was followed by the implementation of new initiatives to intensify and expedite the restructuring efforts of corporates. These initiatives include: inclusion of representatives from Danaharta and the Federation of Public Listed Companies in the CDRC Steering Committee; revision to the CDRC framework and approach with a specific timeline set to ensure effective implementation of the restructuring; and greater discipline among borrowers and creditors where borrowers would be required to undertake operational restructuring and for creditor banks to be more realistic in their recovery expectations; and enhanced disclosure and reporting through the issuance of a quarterly update on the progress of debt restructuring to ensure a more informed market as well as a more comprehensive reporting of the corporate borrowers and the progress of their restructuring. The CDRC has also set a one-year target for completion of the restructuring of key corporate groups.

In addition to debt restructuring, the focus of corporate sector reforms would be on operational restructuring as well. On the staff comments regarding the need for more publication of operational restructuring, the staff may wish to note that announcements and details of operational restructuring are already being made by the respective corporates.

Our authorities are committed to good corporate governance practices. As highlighted in footnote 16 of the staff report on the observance of standards and codes—corporate governance module, Malaysia is in compliance with most of the key features of regulatory requirements relating to shareholders' rights, oversight of management, and disclosure and transparency.

Our authorities regret to inform the Board that it would be detrimental to Malaysia to allow publication of the Article IV staff report and the Selected Issues paper. The existence of several sweeping statements and flawed remarks and conclusions could fuel misperceptions and undermine stability in the financial markets. Many statements are not only inaccurate but "alarmist" and could immediately create uncertainty and destabilize the markets. There are numerous such statements, but a few examples are cited below:

Malaysia, like its neighbors, is characterized by an "insider" system of corporate governance; a few large corporations own a significant proportion of financial assets and productive capacity (Box 4, page 12).

The current set of policies, involving the combination of an exchange rate peg with low interest rates and an expansionary fiscal policy, could become inconsistent (paragraph 23, page 17).

Escalating capital outflows and recent reserve losses underscored the fragile market sentiment and investors' sensitivity to the peg…pressures on the ringgit could be renewed (paragraph 23, page 17).

The team expressed serious concern about the prospects of substantial short-term capital outflows this year, which would more than offset the envisaged current account surplus, even in the absence of any external shock (paragraph 24, page 19).

Given the possible acquisition of additional privatized projects this year, the government could be taking on implicit contingent liabilities ... if … realised ... the fiscal position and debt profile could deteriorate rapidly, with adverse implications for market confidence and growth prospects (paragraph 30, page 21).

Given the authorities' determination to continue with the peg, the staff urges that they stand prepared … to adjust other policies… including a tightening of interest rates... Such policy reaction would risk output contraction with negative implications for deteriorating financial and corporate balance sheets that could lead to a negative cycle similar to the one that exacerbated the 1997–98 crisis, but there would be little alternative, given the exchange rate regime chosen by the authorities (paragraph 47, page 25).

In conclusion, our authorities would like to reiterate their commitment to maintaining macroeconomic stability and to pursuing the current macroeconomic and structural policies for more broad-based and sustainable growth over the medium term. The fixed exchange rate regime will remain in place as long as the prevailing rate is well supported by the underlying macroeconomic fundamentals. Policies are directed at strengthening these fundamentals, while improving Malaysia's aggregate competitive position.

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

For a number of years, since the 1997-98 crisis, the Malaysian economy has shown impressive signs of recovery, supported by reasonably prudent macroeconomic management, coupled with structural reforms, in an environment of financial stability. Looking forward, the course of economic recovery in Malaysia is being challenged by the global economic slowdown. Consequently, and in spite of the enviable performance so far, significant risks to the recovery have emerged; exports are on a downward path since the beginning of the year, and significant capital outflows led to losses in reserves, thus raising concerns about external vulnerability. These developments raise questions about the appropriateness of the current policy mix to overcome the consequences of the global weak economic environment, in particular the accommodative monetary and the expansionary fiscal policies. This question takes more importance in view of the need to mitigate the impact of the external outlook, minimize uncertainty, and enhance confidence.

While the overall macroeconomic framework is broadly consistent and has served Malaysia well so far, in light of the sharper than expected deceleration of the global economic activity, we are of the view that some changes need to be considered by the authorities in order to counter the impact of this prolonged slowdown.

The most important issue in our view is in the appropriateness of the exchange rate regime. In this regard, we understand the authorities' concerns regarding the consequences of a modification of the exchange rate system at this time. We however fear that even with contingency measures, the room for maneuver may not be sufficient under a fixed exchange rate to cope with the regional and global developments. The maintenance of a fixed exchange rate can be achieved only with appropriate supporting measures.

While in the past the fixed exchange rate system had a favorable impact on net inflows, the recent turnaround in capital movements and the resulting losses in reserves raise doubts about the viability of maintaining the pegged system. Although we take note of the fact that non-recurring factors contributed to the acceleration of capital outflows, we are concerned that more fundamental issues—such as the real effective appreciation of the ringgit—

coupled with more volatile financial markets environment and negative investors' sentiments will not stem these outflows.

Furthermore, the slowdown in exports is adding to Malaysia's external imbalances. As the export base is very dependent on electronics and electrical products, the decline of exports is largely due to the weakening of the global environment. However, the ringgit appreciation represents also a factor behind the sluggish exports. In this regard, given the country's heavy reliance on exports, a flexible exchange rate system would be better suited to offset the impact of external shocks on the balance of payments. Moreover, we concur with staff that the weakening of other regional currencies may weaken Malaysia's external competitiveness and generate pressures on the ringgit. This would lead us to believe that greater flexibility in the exchange rate is warranted, better sooner rather than later. Such flexibility would also serve to moderate capital movements.

The issue of the exchange rate regime should also be considered in the context of the overall policy framework. It appears to be a conflict between the different objectives assigned to the monetary policy; defending the peg, keeping inflation under control, and at the same time, maintaining the interest rates levels. Furthermore, setting a minimum target for commercial banks' credit is inconsistent with achieving transparency in the conduct of monetary policy, and could jeopardize the quality of bank lending. If the peg needs to be maintained, monetary policy should be more flexible, through the use of market-based instruments and the gradual liberalization of the interest rate structure.

The combination of the fixed exchange rate regime and expansionary fiscal and monetary policies raises the risk of potential speculative pressures on the ringgit. If the fixed-rate regime is maintained, to preserve the consistency of the policy, other policy instruments such as fiscal policy or interest rates need to be adjusted. In this regard, while we agree with the staff on the need to continue using the fiscal policy to bolster domestic demand, we are concerned by the implications that the fiscal expansion might have on market sentiments, as well as on the foreign reserve position. We believe there is a choice to be made between the different targets, in order to ensure consistency and minimize risks. We leave it to the best judgment of the authorities how to approach these issues.

Before concluding, we would like to briefly comment on structural reform. The Malaysian government needs to put all its efforts to improve investors' perceptions in the country and strengthen their confidence. In this regard, we welcome the policies aimed at attracting foreign direct investment as well as the further cautious liberalization of the capital account and financial sector reform. More progress is however needed on restructuring the corporate sector and deregulating the financial system. The staff pointed out clearly the steps to be taken in this direction. We fully support their views.

In conclusion, we again commend the Malaysian authorities for their prudent economic management and wish them every success in mapping their economy in what could be turbulent times ahead.

Mr. Wijnholds submitted the following statement:

Malaysia has a strong record as regards economic performance, and the 8 percent growth rate and low inflation achieved last year illustrate what the country is capable of. This year the global slowdown is affecting Malaysia's output performance strongly, underlining its high vulnerability to changes in the global demand for electronics. The deterioration in the market's confidence with respect to Malaysia seems to be also due to doubts about the sustainability of the policy mix and the rather slow pace of corporate restructuring. I will first comment on monetary and exchange rate policy, where Mr. Low and Ms. Phang's comprehensive statement makes clear there are significant differences of opinion between the authorities and the staff. I will then briefly focus on some other issues, including the financial sector and fiscal policy.

On monetary and exchange rate policy, I would emphasize that I support the fixed exchange rate regime in the short run. This is not a good time to shift to a new regime, as the staff recognizes. The difficult question is whether in the longer run a flexible regime is better suited to Malaysia's conditions, as is suggested by the staff, but challenged by the authorities. If the shift to floating would indeed lead to a precipitous depression of the ringgit, one can question the wisdom of such a move, especially for a very open economy such as Malaysia. Economic theory tells us that the more open the economy, the higher the adjustment costs associated with expenditure switching policies (i.e., depreciation) and the smaller the costs on account of expenditure changing policies. The Fund view has moved quite far to the 'corner solutions' or 'bi-polar' approach on exchange rate regimes. It is not all that obvious that the pole that Malaysia should move to—if at all—is the floating one. Hence, recommendations to do so must be made very carefully. This is clearly a case where reasonable people can hold a different view. I can therefore understand the concerns of the Malaysian authorities with the recommendation of the staff. Indeed, I cannot recall that for, for instance, Argentina we ever recommended in an Article IV report to have to exit from its fully fixed regime, despite the build-up of a competitiveness problem, which—it seems—does not exist for Malaysia.

Where I do agree with the staff, however, is on doubts that the present macro-economic policy mix is fully appropriate in light of the wish to maintain the peg. While there is a strong case for a stimulative fiscal policy at present, it seems that, in combination with an accommodative monetary policy, pressure on the exchange rate will be hard to avoid. Recent reserve losses point to this problem. In the meantime, lower interest rates in the United States have helped ease the problem and the policy dilemma has lessened. Nevertheless, I agree with the staff that under the present policy of a dollar peg for the ringgit, monetary policy has to be available to defend the exchange rate by means of higher interest rates if renewed outflows occur. A judicious mix of intervention and somewhat higher interest rates need not be detrimental for growth also in view of the present expansionary fiscal policy. To apply the alternative, i.e., to impose capital controls to defend the exchange rate would be unfortunate. I am pleased to see that the authorities have actually been dismantling the capital controls that they erected several years ago. Let me emphasize that I am not dogmatic about restrictions on capital movements, and would not exclude them in crisis situations, but that I am convinced that they will not be in Malaysia's long-term interest if reinstated under other than exceptional circumstances.

Let me welcome the BNM's bills reintroduction and its plan to use market-based instruments for liquidity management. I also welcome the implementation of guidelines on credit risk management by banking institutions. This should help banks to set appropriate and independent deposit and lending rates. In other words, to set interest rates on their own, without governmental directives. The subsequent step should be the abolition of the ceilings on the lending rates and of the BLR.

These measures will support a more liberal interest rate policy, and will tend to improve resource allocation throughout the economy. Resource allocation would also benefit from avoiding the practice of lending directives. In this regard, I would encourage the BNM to abandon its policy of issuing guidelines to banks on minimum lending targets to specific sectors. In addition, I believe it is questionable for BNM to extend a certain amount of credits to specific sectors from its own resources. Although the aggregate amount of these credits is not significant, the principles of prudent central bank practices should not be disregarded.

As regards financial sector issues, I am pleased with recent developments. In particular, I note the achievements in the area of risk-based and consolidated supervision of financial institutions. This is still an ongoing process, but extremely important if the economy is to become more flexible. However, I have some concerns related to the banking system's soundness in light of limited success in corporate sector restructuring. More precisely, it could hardly be expected that banking institutions have become sounder in an unchanged environment of corporate structures and the "insider" system of corporate governance. In this regard, the authorities would do well to accelerate corporate restructuring, particularly its operational part.

In addition, with regard to the financial sector, I would like to comment on the issue of deposit insurance. I certainly welcome the authorities' plan to remove full coverage of deposit insurance and introduce a system with limited coverage, but I would like to underline the limited effectiveness of the deposit insurance scheme in the case of Malaysia in general. Indeed, given the fact that the majority of banks are in government hands, the purpose of the deposit insurance scheme could be questionable, since it could be expected that the government will support its banks in the event of distress. In this regard, even limited coverage cannot be expected to significantly ease the moral hazard problem.

Turning to the fiscal stance, I support the assessment that fiscal sustainability in Malaysia is still not in question, despite the substantial fiscal deficit and rising public debt. This year's fiscal stimulus has been broadly appropriate. However, I share staff's concerns about the efficient use of budgetary resources. In particular, concerns related to the government's purchase of Malaysia Airlines, which imposed a significant cost on this year's budget.

As regards the announced fiscal consolidation, I welcome the authorities' plan to balance the budget over the next two years. This will certainly help to limit further public debt growth, but it will also positively affect market confidence.

Finally, I believe that for restoring market confidence it will be crucial to accelerate operational corporate restructuring. In addition, I want to reiterate that in moving forward, more market based macroeconomic policies will have to accompany the reforms in the structural area. The authorities have proved in the past that they are capable of a sound and wise management of the economy and I wish them success in their efforts to further improve Malaysia's performance.

Mr. Guinigundo and Ms. Davidson submitted the following statement:

With the adverse shift in the global economy, the present situation in Malaysia is quite different from what we saw during the Article IV consultation last year. As the staff report and the comprehensive statement of Mr. Low and Ms. Phang indicate, Malaysia has not been spared from the slowdown in the U.S. and Japanese economies and global electronics demand. Of course this story is not unique to Malaysia. It is true for many countries that thrive on electronics and trade with major industrial countries, particularly the United States and Japan.

For the most part of the period after the Asian financial crisis of 1997, Malaysia has achieved macroeconomic stability coupled with high growth, low inflation, and an impressive external payments position.

Four years on, Malaysia now faces the task of managing the difficult challenges of broadening the sources of growth, refining the conduct of monetary and fiscal policies and reforming the corporate and financial sectors.

We shall limit our comments to the second and third of these major issues (i.e.., conduct of monetary and fiscal policies and corporate and financial sector reforms). On the first issue, there is general agreement on the need to diversify and further transform Malaysia into a stronger, more resilient economy.

We share the concern of the staff that the significant capital outflows reported for Malaysia put into question the sustainability of the peg. Although the situation seems to have stabilized more recently, and Malaysia is better placed to manage a potential crisis than was the case in 1997, we can sympathize with the staff's concern regarding the possible risk of the current set of policies becoming "inconsistent."

There is no place for any dogma judging the wisdom of the policy mix—unanticipated changes may occur that may necessitate adjustment of the mix. It is also worth noting that market perceptions can change rapidly, particularly in the current global environment. The key issue is whether the country's specific economic circumstances are fundamentally strong and the policy mix appropriate to make the exchange rate system work well.

We believe that the Malaysian authorities have handled the exchange rate arrangement and monetary policy well in recent years. In addition, there does not seem to be an overwhelming case to modify the existing policy approach, for the moment.

Although there has been some loss of competitiveness recently, Box 7 admits that the ringgit is not significantly misaligned.

Malaysia has maintained its share of world exports since 1996. The increase in the share of both China and Korea does not necessarily prove Malaysia's loss of competitiveness because these countries are not necessarily competing in the same market and in the same product with Malaysia.

There was a drop-off in Malaysia's exports in the first half of 2001 but as noted in Box 7, this was consistent with export declines across the region, "despite Malaysia's relatively heavier dependence on electronics products."

Against this background, and noting that interest differentials with the United States are declining; regional exchange rates have stabilized; the U.S. dollar has begun to show signs of weakness; and capital outflows from Malaysia have abated, the Malaysian authorities' judgment on monetary policy, in the face of what they have seen as temporary factors, seems sound.

In the same vein, we can understand the authorities' disagreement with staff's recommendation to raise interest rates at a time when global interest rates are coming down and economic growth needs some nurturing. At best, this option should be available to the authorities in defending the fixed exchange rate.

Staff suggest that, in the absence of a shift to more flexible exchange rate arrangements, the authorities in Malaysia should underpin confidence in the regime by making it known to market participants that they stand ready to adjust policies as necessary to defend the peg. We have some concerns with this suggestion. It is open to debate how the market might interpret this type of statement. While it could, as the paper suggests, help strengthen confidence in the regime, there is also the possibility that the market may seize on the commentary as an admission that the peg is in 'trouble.' Nevertheless, we are reassured by the authorities' commitment to take the necessary actions in the event of an acute external shock.

With regard to capital controls, we note that Malaysia has shown itself willing to wind back controls when deemed no longer necessary, and taken advantage of the breathing space provided while they were in place to reform its financial system.

Looking ahead, we are confident that the authorities, who continually monitor all indicators of economic activity and liquidity as well as international capital market situations, will come to a decision that, if economic and financial conditions continue to worsen and reduce their own scope of policy choices, the current exchange rate and monetary policy framework will have to be revisited to achieve greater flexibility in responding to such challenges.

In light of the significant slowdown in growth, the decision to defer fiscal consolidation is understandable. Nevertheless, while public debt remains manageable, we note that investors are already concerned about fiscal sustainability with total public sector debt at around 67 ½ per cent of GDP, and although it may not have had significant consequences to date, as noted previously, investors' perceptions can change rapidly. We agree with staff that it is important to begin the process of consolidation soon and welcome the authorities' intention to begin next year. However, should the slowdown be more protracted than expected, there could be a risk that consolidation will again be delayed. Needless to say, the longer that it is deferred, the more concerned investors are likely to become and the more difficult the consolidation task will be.

We share staff's view that it would be problematic to use public funds to acquire infrastructure projects in financial difficulty. As staff note, the acquisition of such assets may send negative signals about the commitment to following market principles and good governance practices. We support staff's call to strengthen efforts to monitor public debt and all potential liabilities of government.

We commend the authorities for the progress they have made in financial sector consolidation and restructuring and in enhancing banking regulation and supervision. Further, it is encouraging to read in Mr. Low and Ms. Phang's statement that there is a cushion to absorb an increase in non-performing loans arising from the slowdown. We would be interested in comments from staff on this issue, such as whether any sensitivity analysis has been conducted indicating the extent of a possible increase in NPLs with slower domestic growth.

The authorities have also made commendable efforts to adopt best corporate governance practices, and we encourage further progress in this area along the lines suggested by staff. Further progress in corporate operational market restructuring is important for investor confidence.

In the current environment, and in light of some of the sensitive issues discussed in the staff report, we can understand the authorities' decision not to publish.

With these remarks, we extend our best wishes to the authorities for success in pursuing their interesting approach to achieve more sustainable economic growth and better quality of life for their people.

Mr. Kelkar submitted the following statement:

At the outset, we would like to thank staff for a set of useful documents and Mr. Low and Ms Phang for their insightful statement. After its remarkable post 1998 recovery, growth has recorded a slowdown in Malaysia during the current year, reflecting the global downturn in this trade-dominated economy. This has been manifested by a declining current account, consequent to lowered exports, and moderation of investment and capital outflows. However, inflation continues to be low, external debt is manageable while reserves are comfortable.

In this environment, we support the authorities efforts to stimulate domestic demand through an expansionary fiscal policy to compensate for the external slowdown. While this would raise the fiscal deficit, we note that the thrust of this initiative would be in infrastructure, housing, and education. This would enable the expenditure to be more domestically oriented and not significantly add to pressures on either inflation or the external current account. We also support the intention of the authorities to embark on a consolidation exercise next year targeting a balanced position in three years. In regard to the takeover of financially strained infrastructure projects, we agree with staff on the need for a measured approach, which would demonstrate the authorities commitment to corporate best practices while simultaneously minimizing the assumption of contingent liabilities.

A recurring theme during previous Article IV consultations has been the advantages that would accrue if Malaysia adopted a flexible exchange rate system. This year, once again this issue receives attention. The staff argue that the authorities should consider such a policy, given that the economy's high dependence on exports make it vulnerable to external shocks, such as the present downturn. This would enable it to effectively counter pressures on the ringgit, if regional currency depreciation were to resume. The authorities, on the other hand are equally convinced that with the existing fundamentals, the ringgit is not significantly overvalued and the present system continues to be appropriate. They clearly place great emphasis on exchange rate predictability, and feel that competitiveness can be enhanced through improvements in productivity. We support the viewpoint of the authorities, especially as the staff itself points out that the 'exchange rate might not be significantly misaligned from a longer term perspective'.

Further, as Malaysia has demonstrated in the past, some of the solutions preferred by them have served them well. This is exemplified by its decision on the imposition of capital controls, which, as Kaplan and Rodrik have found, was a viable alternative to more conventional approaches. As pointed out by Mr. Low and Ms. Phang, the specific circumstances of a country would need to guide its policy choices, and clearly in the case of Malaysia, the authorities have unequivocally opted for a pegged system, for which they have demonstrated strong ownership. Their concerns about the onset of greater uncertainty and instability in the market if a flexible system were adopted at this stage need to be appreciated. The statement in the statement that the authorities are keeping all policy options open as mentioned in the statement also provides reassurance. As pointed out by Mr. Wijnholds, we need to support the authorities by providing them with consistent advice.

With nearly 60 percent of its exports comprising electronics and electrical goods and the United States being its largest export market, we urge the authorities to move forward quickly in their efforts to diversify their export base, through promoting trade in services as well as moving up to higher value added products. While we note the significant progress achieved in financial sector reform, we agree that the economic downturn may put pressure on the banking sector in the form of increased NPLs. We therefore would like to underline the need for operational restructuring in the corporate sector to mitigate such pressures and note that this has been emphasized in the statement. Despite the need to spur investment, we would have preferred not to have a target set for credit growth. We are however reassured by the intention of the authorities to treat this in a flexible manner.

We commend the Malaysian authorities on the high quality of their economic statistics and their compliance with all the requirements of the SDDS. In this connection we agree with the authorities that ‘excessive disclosure requirements and transparency could be potentially destabilizing since market participants tend to react to short term developments while overlooking fundamentals.’ As pointed out by this chair during the discussion on SDDS, the high degree of disclosure stipulated in the international reserve template may not be in the best interests of developing country economies. The possibility of this leading to speculative arbitrage exists - with the financial markets attempting to speculate on possible intervention strategies, which may be adopted by the authorities. We would encourage staff to revisit these developing country concerns, given the potential adverse implications of excessive disclosure requirements, particularly in these turbulent times.

In conclusion, we commend the authorities for the skilful management of their economy and wish them continued success in their challenging policy endeavors.

Mr. Rustomjee submitted the following statement:

We thank the staff for their assessment of developments in Malaysia and Mr. Low and Ms. Phang for their detailed and useful statement. Malaysia has made tremendous progress in restructuring the economy since the Asian crisis. As a result the recovery process had gained momentum and output growth strengthened. Unfortunately the ongoing decline in global demand is having a significant impact on Malaysia’s recovery process, requiring the authorities to take measures to contain this impact and to remain vigilant. We welcome that there is broad agreement between the staff and the authorities on the economic outlook, the fiscal policy stance, financial sector reforms, and the agenda for structural reforms. We will comment on monetary and exchange rate policies where there seem to be some divergence of opinion between the authorities and the staff.

It is appropriate that fiscal consolidation measures have been postponed in order to stimulate demand and to contain the slowdown in the economy. In our view, the fiscal stimulus may still be far from igniting inflationary pressures given that it is being administered in the context of excess capacity. With very low inflation in Malaysia, and inflationary pressures remaining subdued, we feel that low interest rates could be justified. Low interest rates have assisted the banking sector in absorbing the costs of restructuring and have helped to speed up the process. We welcome that the observation that the financial sector remains sound. The corporate sector has also taken advantage of low interest rates to reduce its indebtedness, thereby minimizing the external vulnerabilities of the country. We welcome that the authorities are introducing indirect instruments for monetary policy management. On the fixing of lending rates, we note that this appears to be done without compromising the profitability of banks and, while this may not be a market based mechanism, we wish to underscore that despite the progress achieved in financial sector liberalization, implementation of structural reforms and the deepening of financial intermediation, the problem of large spreads between lending and deposit rates is prevalent in most of our countries. Looking ahead, we urge the authorities to continue monitoring developments very closely, given that a severe worsening of the external situation could pose a serious challenge to the current policy mix.

Regarding exchange rate policy, it is important to acknowledge that economic fundamentals remain relatively strong in Malaysia and the staff has noted that the global slowdown is expected to weaken, but not derail the recovery in the country. The current account remains in large surplus, slowing exports are matched by deceleration of imports, short-term external debt is low and reserves remain adequate, while a significant portion of capital outflows have been geared towards reducing the external indebtedness of the corporate sector. Substantial progress has been made in strengthening the banking system and the recent bond placement was successful, underscoring investor confidence in the country's fundamentals. Moreover, the staff report concludes in Box 7 that stagnation in exports in Malaysia has been in line with the slowdown of export demand across the region. In addition, FDI inflows have shown resilience, compared to other countries in the region, and recent capital outflows have receded as currencies in the region have stabilized and interest rate differentials with the United States have narrowed.

Against this background, we concur with the position of the authorities, as elaborated in Mr. Low and Mrs. Phang's statement, that a major change in exchange rate policy at this time may not be warranted as it could have undesirable consequences. Given the current global slowdown, and in a region where countries export similar products and compete for the same export markets, a major shift in Malaysia's exchange rate policy could spark competitive devaluation within the region, prompting a region wide tightening of monetary policy that could worsen the downturn.

We welcome the contingency measures taken and the authorities' readiness for further adjustments if warranted by the situation. However, we would expect the authorities to revisit their position on exchange rate policy if the global downturn turns out to be more severe and if accompanied by a major weakening of regional currencies against the U.S. dollar and the Japanese yen. The statement by the staff representative seems to be pointing to a further worsening of the situation in Malaysia as a result of the deepening global downturn. Moreover, the authorities may need to pay attention to medium and long-term issues that could improve external competitiveness, particularly as competition from China and Korea has intensified. We support efforts underway to diversify the economy away from electronics sector. Structural measures need to be deepened, including labor market liberalization. Efforts being made to invest in education and to transform Malaysia into a knowledge-based economy will be helpful in this regard.

Finally, given the foregoing, we support the reservations expressed by the authorities on publication of the staff report.

Mr. Tombini submitted the following statement:

After a strong recovery in 1999 and 2000, the Malaysian economy has significantly slowed in 2001 consistent with the deceleration of the global economy. Vigorous output growth led by export performance in the last two years has been followed by clear signs of deceleration, a peculiar development in other fast recovering post-crisis Asian economies that share the common feature of high dependence on technology-based exports. On the domestic side, consumption and investment growth has remained quite modest, with a recent policy induced pick-up in domestic demand. After growing over 8 percent in 2000, the Malaysian economy is projected to expand only 2 percent in 2001, with considerable downside risks as pointed out by the staff. As a result, the authorities, as in other parts of the world, are confronted with the challenge to smooth out the domestic consequences of an adverse global environment, without resorting to policy inconsistencies that could undermine credibility, and bring about higher costs in the medium to long-term horizon.

In this regard, the current macroeconomic policy stance adopted by the authorities, combining expansionary fiscal and monetary policies under a rigid pegging of the currency, is particularly concerning. In spite of relatively well-contained vulnerabilities, at least in the short term, we concur with the staff's view on the need to demonstrate readiness to adjust the policy mix, should a further deterioration in the external scenario take place, whether at the regional or at the global levels. In the absence of such response, the stance of economic policy could result incompatible and lead to more costly adjustments in the future, with deeper and more durable negative impacts on the domestic economy.

At the current stage, given the improvements achieved with respect to building a more resilient financial system and also in face of limited external vulnerability, the accommodative policy stance appears to be adequate and consistent with low levels of capacity utilization and subdued inflationary pressures. Likewise, Malaysia's capacity to still generate substantial surpluses in the trade balance with large export revenues of oil and electrical sectors mitigates, under the present circumstances, potential policy inconsistencies. Nevertheless, this latter factor depends upon the depth and duration of the current global slowdown, providing no assurances to the authorities on the compatibility of macroeconomic policies in the near future.

On the fiscal side, the current accommodative stance is coherent with the need to counterbalance the effects of the global slowdown on the Malaysian economy and to moderate the risks that could otherwise arise in the corporate and financial sectors. Notwithstanding the genuine objective behind the supportive fiscal stance, the limits to additional fiscal stimulus are rather clear. First, the current overall government deficit is already sizeable. Moreover, taking into account off budget expenditures, this fiscal imbalance would certainly be reasonably larger, which in turn adversely affects market perceptions regarding public sector financing needs. Furthermore, the underlying fiscal stimulus is larger than what surfaces from public sector accounts.

We appreciate the authorities' plan to commence a fiscal consolidation exercise starting next year. In this respect, we understand that a comprehensive coverage of public sector accounts is required in the assessment of fiscal stimulus and sustainability. All fiscal and quasi-fiscal operations should be consolidated in a transparent manner, and public debt data should be extended to cover nonguaranteed domestic debt of public enterprises. Is the consolidation exercise also intended to broaden the coverage of public accounts?

Regarding monetary policy, we concur with staff that in the event of a more adverse external development and given the authorities' commitment to the current level of pegging, there is the need to be prepared to use all instruments. We were pleased with the clarification provided in Mr. Low and Ms. Phang's statement that the authorities will continue to monitor a variety of indicators and the benefits of all policy options to prepare for any eventuality.

As to the developments in money and credit markets, we are pleased to notice the remarkable stability of the term structure of interest rates, even against the recent background of foreign reserve losses. Moreover, we welcome the flexibilization of restrictions on the formation of market lending rates, as well as the decision to implement credit growth targets in a flexible manner. The latter is particularly important, as pointed out by staff, to avoid undermining progress made in prudential standards and hence limiting the deterioration in the quality of banks' portfolios as the economic slowdown occurs.

Finally, we commend the authorities for progress achieved in reforming the financial sector and support their additional efforts to mitigate existing vulnerabilities, in particular, the need to increase transparency in the process of corporate sector reform underway, and in addressing other issues related to good corporate governance, such as the need to strengthen minority shareholders rights.

Mr. Zoccali and Mr. Maino submitted the following statement:

We welcome the well-written Article IV consultation report and focused selected issues paper. We are also grateful to Mr. Low and Ms. Phang for their comprehensive and candid statement on Malaysia's recent economic performance and the authorities' policy stance.

In the context of a worldwide slowdown, Malaysia, like other countries in the region, is experiencing downturn in growth, following a strong expansion of GDP in 2000. The openness of Malaysia's economy, and the maintenance of strong fundamentals, after the 1997 Asian crisis, provided the economies of scale and the skill and technology transfers needed to support rapid output growth. The downside is its dependence on a vibrant world economy, as Malaysia's manufacturing and export sectors are adversely affected by deceleration in the United States, the European Union, and Japan and the persistent strengthen of the U.S.. dollar.

The recent acceleration of reforms in the financial and corporate sectors and the strengthening of the regulatory framework, undoubtedly contributed to the relatively positive performance of the Malaysian economy and better position it to withstand the difficulties associated with a steeper downturn as a result of its solid fundamentals, effective debt management and sound financial system. Additionally, we concur with Mr. Low and Ms. Phang that the high level of bank's risk weighted capital ratio and the manageable rate of net non-performing loans point to the resilience in the banking sector. The more diversified economic base and improved inventory management provides the economy with additional instruments to respond to the adverse impact of the global economic slowdown. In this sense, the staff report is right to focus on the issues, policies, and institutional reforms to ensure a smooth recovery and a sustainable strong rate of growth. We will confine our comments to two aspects, namely, the extent to which domestic stimulus can offset the steep downturn in export manufacturing and the viability of a pegged exchange rate.

Strong fundamentals have to date afforded Malaysia the room to implement pro-growth policies to strengthen domestic demand and thereby mitigate the adverse impact of the global slowdown. Nevertheless, concerns about the medium-term sustainability of the fiscal stance and pressures on the capital account should the global economic downturn become more protracted, suggest the desirability of accelerating the fiscal consolidation efforts embedded in the Eighth Development Plan.

The combination of a stimulative fiscal policy and an accommodative monetary stance increase the risk of exposing Malaysia to a rekindling of speculative pressure on the ringgit as noted by staff, should other currencies in the region depreciate further. In particular, although we welcome the announced reduction in the corporate tax rate, however, the acceleration of infrastructure spending and use of public funds to acquire privatized projects raise possible questions of time-consistency and efficiency losses that may be associated with the acquisition of additional privatized projects. The use of budgetary resources for this purpose could give rise to contingent liabilities and put an extra burden on public sector debt management. More importantly, the acquisition of financially troubled projects could weaken the signal of the government's commitment to market principles and best governance practices. In any event, we fully endorse authorities´ efforts to strengthen the revenue collection system and to further reduce supply-side distortions.

Box 1 of the main staff report on capital flows to Malaysia links the decline in FDI since 1997 to weaker economic prospects and to uncertainty about Malaysia's policy on capital controls. Staff might wish to comment on the extent to which net FDI flows and economic activity more generally may be helped by further easing of capital controls, building on the progress made in financial and corporate restructuring. As noted in the World Bank Report on the Observance of Standards and Codes, the authorities´ strategy to consolidate business confidence an ease vulnerabilities in the corporate sector shows notable advances in the application of best practices in the corporate sector, corporate debt restructuring and the consolidation of the banking sector, including regulatory requirements relating to share holders´ rights, oversight of management and disclosure and transparency. Given Malaysia's high savings rate, maintaining fiscal discipline while improving the framework for private investment would in our view offer the most effective means to counteract the effects of the external demand slowdown and dispel doubts regarding the sustainability of the authorities´ outward-oriented strategy.

The staff asserts that "the policy dilemma in the near term demonstrates that a fixed exchange rate system may not be adequate to cope with future external shocks" and a more flexible exchange rate system would be more suited to Malaysia's economic structure. In this regard, we consider that:

First, it would not be appropriate for Malaysia to opt for a modification of the exchange rate system at this stage of the economic cycle given the external conjuncture of worldwide slowdown. Any move in this direction is likely to promote further uncertainty, pressures on the exchange rate and have negative implications for the stability of the domestic financial system.

Second, it is inconsistent policies and weak fundamentals, not the size of capital flows or the level of external demand, that ultimately will make pegged systems unsustainable. As Mr. Fischer recently stressed, "to put the point graphically, if exchange rate arrangements lie along a line connecting free floating on the left with currency boards, dollarization, or currency union on the right, the intent was not to remove everything but the corners, but rather to pronounce as unsustainable a segment of that line representing a variety of soft pegging exchange rate arrangements." The challenge for a country such as Malaysia that aspires to remain open to international capital flows is to maintain its macroeconomic policy consistency while enhancing the predictability in its monetary framework.

Third, we concur with Mr. Low and Ms. Phang that the idea of asserting that the standard approach of flexible exchange rates is the optimum arrangement for all countries at all times is flawed. In the case of Malaysia, with trade at more than 200 percent of GDP annually, exchange rate stability is important. Its sound fundamentals suggest that responding to cyclical factors leading to a temporary decline in reserves could produce greater uncertainty, higher inflation, and debt servicing costs, and exert an unwanted destabilizing effect on the financial system.

Fourth, the fixed exchange rate regime has afforded Malaysia the necessary stability for reforms to be introduced following the crisis in 1997, while allowing market participants a longer-term horizon within which to assess investment prospects, which was the hardest hit component of domestic demand in 1997/98. In this sense, we concur with the authorities´ view that a stable exchange rate is a powerful competitive tool and that competitiveness would be more sustainable if it were achieved through enhancing productivity and reducing the cost of doing business.

In sum, the more appropriate focus should be on helping the authorities to underpin their chosen exchange rate regime. In this regard, the elimination of inconsistencies that impair the smooth functioning of the money market, such as the restrictions on interest rate spreads, the strengthening of the medium-term fiscal framework and further progress in credit risk management and in the implementation of structural reforms to ensure the supply side response, offer Malaysia the best prospects to reduce the vulnerabilities posed by the global downturn and maximize Malaysia's contributions to regional economic activity.

We wish the Malaysian authorities every success in their endeavors.

Ms. Phang, extending her remarks, made the following statement:

At the outset, I would like to commend staff for the tremendous amount of effort that they have put into the whole mission. The mission team certainly had worked very hard; I was with them everyday, and I could see how hard they were working. I have no doubt that they really tried very hard to present a balanced and fair assessment of the economy. But, judging from the statements made by several Directors in their preliminary statements, I think that it is important for me to make certain clarifications and comments.

I feel that my authorities are justified in expressing their dissatisfaction with staff's presentation of certain aspects of the Malaysian economy as they could give rise to misperceptions, and it appears that that has occurred among certain Board members despite the fact that we have very well-informed Directors. While I will leave staff to answer the questions raised in the preliminary statements, allow me please to comment on the issue of the exchange rate regime and to make some clarifications on staff's update on the economy.

First, several Directors had commented on the conflict in the Malaysian policy mix and the current pegged exchange rate regime. We acknowledge that an expansionary fiscal policy and an accommodative monetary policy in an environment of current account deficit, high inflation as well as large differentials between home country interest rates and international interest rates, could give rise to possible inconsistencies between a pegged exchange rate and the underlying economic fundamentals. Under such a "hypothetical" scenario, the exchange rate could be misaligned with the fundamentals of the economy, and thus raise the risk of potential speculative pressures on the currency.

However, in the case of Malaysia, I would like to question whether staff really found that with a pegged exchange rate, we also had a serious current account deficit, high inflation, and large interest rate differentials? If so, then they are justified in saying that there is inconsistency. However, it is obvious from comparing the hypothetical situation with the actual situation in Malaysia, that the current policy mix remains consistent with a pegged exchange rate. In contrast to the hypothetical scenario, Malaysia's current account is in surplus, inflation has been stable and low at 1.5 percent, and the differential between domestic and international interest rates is currently insignificant. Hence, in the current environment, the pegged exchange rate regime is in line with the fundamentals of the economy.

Furthermore, I would like to stress that monetary policy in Malaysia has only one objective, namely, price stability, not many objectives as alleged in some statements. However, since we had an environment of low inflation, we were able to keep the interest rate low. This, together with the pegged exchange rate (which is in line with the fundamentals), was therefore a consistent policy mix.

Nevertheless, we do acknowledge that if the exchange rate does become misaligned and inconsistent with the fundamentals of the economy, we would have to reevaluate the pegged exchange rate regime. In this regard, we have considered alternative scenarios and policy options available to us should the exchange rate become misaligned. However, as rightly pointed out by Mr. Guinigundo, there is a limit to transparency, as revealing the authorities' plans or programs to address emergence of misalignments could be misinterpreted by the markets as a sign of trouble and precipitate the very crisis that we seek to avoid as several Director had commented on the need for the Malaysian authorities to demonstrate to the markets its readiness to adjust policies as necessary to defend the peg, I wish to reiterate my authorities' commitment to continue to monitor developments closely and to review all options to maintain a consistent policy mix. The message that my authorities want to send is that Malaysia is committed to sound macroeconomic policies and will take pre-emptive measures to avoid imbalances from emerging in the economy.

I would also like to make clarifications to two main points in the staff's update. Firstly, they said that indicators of financial soundness have worsened and nonperforming loans have increased. While the NPLs have increased in recent months, it is important to highlight that the increase is still manageable and does not in any way pose systemic threats to the overall stability of the financial system. Given the very high capitalization level, there is more than sufficient capital to cushion further increases in NPLs. The capital base of the banking sector is now stronger, with a risk-weighted capital ratio (RWCR) of 12.4 percent, having increased from 12.1 percent in the first quarter. The core capital is 10.5 percent. With an additional "cushion" of more than 18 billion ringgit above the international benchmark of a RWCR of 8 percent, the banking sector has adequate capital to absorb any rise in NPLs arising from the economic slowdown. Secondly, on the adequacy of provisions by the banking institutions, Malaysia has a unique supervisory practice of approving the financial statements of the banking institutions before the accounts are published. This is done on a quarterly or half yearly basis. It is during these exercises that the central bank checks the adequacy of provisions and where necessary, the financial statements of the banking institution concerned would not be approved unless the additional provisions have been incorporated.

In addition, the central bank conducts regular stress testing of the banking institutions, which takes into account different scenarios of increasing severity of an economic slowdown. The NPL level would be the main component that would be affected in these various scenarios. It would also determine the amount of losses arising from these projected NPLs and, therefore, the resilience of the banking system to a slowdown and its ability to absorb the losses.

The second thing that I would like to clarify as far as the staff's update is concerned is that on page 2, paragraph 4, the staff says that the credit expansion has been weaker than anticipated. I would like to clarify that credit expansion was not actually weaker than anticipated. In fact, loans extended by the banking institutions have recorded a resilient year-on-year growth of 6.4 percent as at end-July 2001. If you add on credit from the private debt securities market, total loan growth is 7.3 percent, just marginally below the 8 percent that the government would like to have. But, as the staff itself has pointed out in the staff report, it is not a target that the Malaysian government insists on, and banks are not penalized if they do not achieve that target.

Mr. Wei made the following statement:

I have read with great interest the report in which staff gives us a frank view of the economic situation and the policy stance of the Malaysian authorities. I very much appreciate the comprehensive statement jointly written by Mr. Low and Ms. Phang, which greatly enhances our understanding of the economic policies adopted by the authorities. With the economic slowdown around the world, the Malaysian case gives us an opportunity to assess the authorities' measures in maintaining macroeconomic stability and pursuing broad-based and sustainable growth.

The Malaysian economy grew at an impressive speed of 8.3 percent last year as a result of strong external demand and higher domestic expenditure. The overall economic situation was sound and balanced with a low inflation and unemployment rate, and a strong current account position. More importantly, the authorities have taken the time to proceed with financial and corporate sector reforms. In the report, the staff notes the significant progress made so far. Turning to 2001, the slowdown of the world economy has created difficulties for Malaysia as it has for other Asian economies, putting the authorities' policies to the test. However, based on the strong macroeconomic fundamentals, the authorities have initiated proactive policies, showing their strong commitment to lead the country out of the slowdown and to pursue long-term and sustainable growth.

We support the authorities' overall economic policy framework— accommodative monetary policy, stimulative fiscal policy, and pegged exchange rate regime— to strengthen domestic demand and mitigate the impact of external weakening. We strongly agree with Mr. Low and Ms. Phang that the assessment of the policy mix in Malaysia should take into consideration the country's specific circumstances. On the one hand, the accommodative monetary and fiscal policies are aimed to stimulate domestic demand, while on the other, the pegged exchange rate regime tends to maintain exchange rate stability which is crucial for a country like Malaysia with its trade at more than 200 percent of GDP. We do not think Malaysia should switch to more flexible exchange rate regime in the near future for the reason cited by Mr. Low and Ms. Phang that the exchange rate should not be based on "knee-jerk" reactions to short-term changes in market perceptions that do not reflect underlying fundamentals, but rather only temporary factors. At present the policy mix serves the authorities' purpose well. We should also recognize that the authorities are fully aware of the challenges facing them. They are closely monitoring external developments, analyzing the risks of the banking system and, most importantly, continually reviewing policy options and having contingency policies in place.

We welcome the authorities' progress in financial and corporate sector reforms. The consolidated financial system and strengthened financial regulation and supervision will enhance the efficiency and competitiveness of the financial sector. We note the authorities' plan to address the moral hazard of the blanket guarantees on banking institutions with plans to initiate a deposit insurance scheme. Compared with other emerging market countries, Malaysia has made laudable progress in corporate restructuring, including promoting good corporate governance, as noted in footnote 16 of the staff report. The World Bank Report on the Observance of Standards and Codes reports that Malaysia is in compliance with most of the key regulatory requirements relating to shareholder's rights, oversight of management, and disclosure and transparency, all of which are desirable for good governance. We encourage the authorities to press ahead with these structural reforms.

The staff notes in Box 1 on Capital Flows to Malaysia: Short-Term Capital and Foreign Direct Investment that Malaysia is an attractive FDI destination because of its strong legal system and infrastructure, relatively skilled labor force and favorable investment incentives. The combination of these characteristics and the authorities' policies aimed at maintaining economic stability, strengthening fundamentals, improving labor productivity through education and dissemination of new technologies, and diversifying the economy, will undoubtedly enhance Malaysia's competitiveness and continue to make it attractive to foreign investors.

We sympathize with the authorities on their reluctance to publish the staff report for the reasons given by Mr. Low and Ms. Phang in their statement.

In conclusion, we commend the authorities for their strong commitment to macroeconomic stability, pre-emptive and pro-growth policies, and their foresightedness in preparing the economy for the recovering opportunities and further integration into the world economy. We wish the authorities every success in their endeavors.

The staff representative from the Asia and Pacific Department (Ms. Meesook) made the following statement:

Ms. Phang as well as a few other Directors commented on the divergent views between the Malaysian authorities and the staff on monetary and exchange rate policies. To some extent, the divergence could be less in the analysis and more in the emphasis—such as regarding the risks and the timing--and, therefore, in the conclusions. The staff fully agrees that an exchange rate move during a period of financial market volatility could have a destabilizing effect, while high interest rates could hurt the corporate sector. Hence, we refer to a policy dilemma in the near term.

Based on the authorities' stated policies, there is little scope for making an adjustment except through reserves, as interest rates will remain low, and changes in the exchange rate will be made only when there are changes in the fundamentals. The authorities do not feel that the current policy mix is inconsistent, and believe that a more depreciated ringgit will not improve exports at this time of low external demand. Furthermore, the authorities' analysis on competitiveness emphasizes the current account, whereas capital movements are disregarded as not being related to fundamentals.

The staff concurs that there is no evidence of policy inconsistency at this time; that is, the combination of an exchange rate of 3.8 ringgit to the dollar, low interest rates, and fiscal expansion does not create undue pressure at this time. However, given that the policy mix does not allow much flexibility, there is potential for an inconsistency, which already manifested itself in March and April of this year. Since then, Malaysia has indeed increased reserves somewhat, while the dollar and, therefore, the ringgit have depreciated against the yen and other Asian currencies, lessening the intensity of market sensitivity, and making the position of the ringgit appear more sustainable than earlier in the year. However, the potential inconsistency is still there. It is not too far-fetched to think that the external environment might deteriorate; the yen and other regional currencies could weaken again and/or capital outflows could resume, which would call for more policy flexibility even without changes in the fundamentals.

Given the recent trends of short-term capital outflows, the staff places much emphasis on the capital account and not just on export performance and the current account when assessing Malaysia's competitiveness and whether a policy shift may be warranted. The staff's analysis does not rely only on the CGER exercise. The level of reserves is adequate based on the standard measures; it is $27.5 billion, about three times the level of short-term debt by remaining maturity. But, the amount of net short-term capital outflows, debt and nondebt, in 1999–2000 was about $11 billion to $12 billion each year, almost half of the reserves. So, the scope for using reserves as the only policy instrument is limited.

As mentioned in the staff report, and reiterated by Ms. Phang, the authorities have made contingency plans, but do not want to share them with the staff. Therefore, we are not in a position to report fully to the Board on those policies, or to assess whether they would be adequate to cope with any external shock. Setting aside the option of capital controls, the staff was reviewing the two available options and noted that, if the peg were to stay, Malaysia should be prepared to raise interest rates to defend it as necessary. We are not recommending a rate increase at this time, as in the current situation this could lead to corporate and financial stress. However, if output expansion and low interest rates are critical to the authorities, then they should be prepared to move to a more flexible exchange rate system. As this may lead to volatility in the rate, the timing of the move is important. In our view, a strategic move in a prepared manner is better than being forced to move.

On a separate issue, Ms. Phang stated that it has never been the intention of monetary policy to ensure an adequate profit margin for banks and that the aim of monetary policy is only to maintain price stability. I would like to clarify that the staff was referring to interest rate policy or the policy regarding the interest rate structure, specifically the existence of the base lending rate, which is set according to a formula that puts it a few percentage points above banks' costs of funds, the latter being defined as the BNM intervention rate, which takes into account the unremunerated statutory reserve requirement. The fact that there is such a formula calculated for each bank in itself is an indication that the authorities define margins for banks. Additionally, by maintaining the BNM intervention rate unchanged over the past two years as the interbank market rate declined, this margin has widened.

Mr. Guinigundo and Ms. Davidson asked, in connection with the financial sector, whether the sensitivity analysis pointed to a possible increase of NPLs given the slower domestic growth. At the time of the Article IV mission in May, the staff discussed stress tests conducted by the authorities based on bank-by-bank analysis. The tests indicated that the financial system was robust, even under their worst-case scenarios. A deep and prolonged slowdown in the Malaysian economy would be expected to lead to a resurgence of NPLs, especially as regards previously restructured debt. But, the banking system's risk-weighted capital asset ratios, which are a little higher than 12 percent, would continue to be within the prudent range, that is above 8 percent. Since then, however, the economic situation has deteriorated substantially, possibly approaching the authorities' worst-case scenarios for growth, which were not specified precisely during their discussions with the staff. However, other aspects of these scenarios, which combine a growth contraction with major asset price falls and exchange rate or interest rate shocks, have not occurred, so we do not expect a marked deterioration in capital asset ratios at this time.

Mr. Zoccali and Mr. Maino asked about the extent to which net FDI flows and economic activity may be helped by a further easing of capital controls, building on the progress made in financial and corporate restructuring. The effects of capital controls and their gradual removal is a topic that the staff studied and analyzed in the past three Article IV exercises, including in the Occasional Paper on Malaysia that was issued on Monday.

> The general conclusion is that the controls seemed to have made little permanent differences, positive or negative, to the economic outcome of Malaysia when compared to other crisis countries, especially now that the controls on portfolio flows have been completely removed. The occasion when the impact of easing controls was clearly felt was when the one-year holding period for repatriating portfolio flows was replaced by a levy system in February 1999. That action allowed Malaysia to be reincluded in the major international investment indices and, therefore, capital inflows resumed. In the following September, when the complex levy system was simplified, investors again reacted positively, with portfolio flows increasing noticeably. But, then again, the flows were increasing for other countries as well. The last two steps to remove the remaining controls this year did not seem to produce a discernible impact. In particular, the last action was taken last May when market confidence was very unfavorable. In general, FDI and portfolio flows into the entire region lately have been subdued because of the global slowdown. So, once the global economy picks up, we will be able to tell better how Malaysia fares in terms of attracting inflows. In sum, it is difficult to isolate the impact of the measure and its removal from the effects of the changes in the external environment and domestic restructuring.
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> The last question comes from Mr. Tombini, who asked whether the fiscal consolidation exercise is intended to broaden the coverage of the public sector account to include all fiscal and quasi-fiscal operations as well as the non-guaranteed debt of public enterprises. The short answer is no, the consolidation exercise is limited to reducing federal government deficit gradually in order to reach a balanced position by 2004.

Mr. Wijnholds noted that Malaysia's competitiveness could not be questioned given the size of its current account surplus, even though it had declined recently. Nevertheless, the volume of capital outflows, on the order of $11 billion to $12 billion over the preceding two years, was alarming, and did increase Malaysia's vulnerability. It was likely that interest rate differentials with the United States played a large part in the outflows. However, the authorities appeared reluctant to remedy that problem through recourse to monetary policy because that wanted to preserve lower interest rates because of the weakness of the domestic economy.

The staff representative from the Asia and Pacific Department (Ms. Meesook) agreed that the staff's earlier response should have referred to vulnerability rather than competitiveness.

Mr. Kelkar noted that a study by Kaplan and Rodrik had found that the imposition of capital controls had helped Malaysia to recover better than the other Asian-crisis countries.

The staff representative from the Asia and Pacific Department (Ms. Meesook) replied that there was no clear evidence one way or the other as to whether controls had produced any permanent positive or negative impact on the economic outcome. The staff also had some problems with the methodology used in the study cited by Mr. Kelkar, which compared Malaysia's performance in September of 1998 with that of Thailand of July 1997 and Korea of December 1997, although the study itself had a problem with the Fund's methodology of comparing performances of all the countries at contemporaneous times.

Ms. Phang observed that capital controls had undoubtedly had a significant impact in Malaysia in terms of social indicators. Malaysia's standard of living did not deteriorate and there were not any widespread social problems, which otherwise might have been the case.

In addition, capital controls had been intended to be a temporary measure, and were removed when deemed no longer necessary, Ms. Phang continued.

The differences between the authorities and the staff largely revolved around the fact that the staff placed a lot of emphasis on a hypothetical situation, Ms. Phang explained. The staff did not give proper credit to the authorities for managing the economy well. Instead, it focused mainly on a hypothetical situation as though it were the actual situation, and certain Directors also took the same approach.

If a country used a fixed exchange rate regime, any adjustment would have to occur through reserves, Ms. Phang replied in response to the concern over the drop in Malaysia's reserves. However, as reserves were high, a change in reserves should not be interpreted as indicating that there were serious problems in the economy.

However, recourse to reserves was not the only policy instrument available to the authorities, Ms. Phang continued. If the yen were to deteriorate drastically, and a lot of the ceteris paribus assumptions were changed significantly, the Malaysian authorities would definitely examine other alternatives. Furthermore, such a deterioration would affect all the countries in region, not just Malaysia.

The authorities did not define the margins for banks, Ms. Phang explained. The authorities only specified an upper limit, and wanted banks to compete within the limits. However, the authorities did not want banks to take advantage of the situation and charge excessive amounts to the population, and therefore they had set an upper limit.

Mr. Kelkar noted that the social tensions in Malaysia were much more manageable than in other countries in the region.

Mr. Baukol made the following statement:

> The Malaysian economy recovered fairly well from the turbulence of 1997-98, but it now faces new challenges arising largely from the current global economic environment. Malaysia is heavily dependent on electronics exports. As noted by the staff update, given the continued weakness in external demand from Japan, Singapore and the United States, it appears that exports may slow further than the 2 percent forecast, which could put renewed pressure on the balance of payments position.

The authorities have taken steps to reduce the vulnerability of the economy. As noted by the staff this morning, the banking system has been largely restructured in the past two years, reducing the threat that the growth slowdown will ripple through the economy. Reserves are high relative to short-term debt. And, as noted in the statement by Mr. Low and Ms. Phang, the authorities are focused on maintaining flexible domestic markets to help respond to economic shocks.

But there are several areas of risks, as described by the staff report. We would like to comment on several interrelated issues: Malaysia's corporate restructuring efforts, quasi-fiscal issues, and the pegged exchange rate.

On the corporate side, the ROSC issued in January described the strengths and weaknesses in corporate restructuring and corporate governance in Malaysia. Mr. Wei has described some of the strengths. The weaknesses include opaque relationships between enterprises and managers, highly concentrated ownership structures, and favoritism for well-connected firms. We have two comments.

One, the perception remains in the private sector that the government will actively intervene to support selected high-profile enterprises, both through the stock market and through other quasi-fiscal methods. The planned intervention regarding Malaysian Airlines is one example. These types of interventions can prevent resources from flowing to more productive uses and provide opportunities for corruption.

Second, despite Malaysia's relatively strong performance in financial sector restructuring, the level of FDI remains low relative to pre-crisis levels and low relative to some other countries in the region. We think this can be attributed, in part, to concerns of foreign investors about corporate governance issues and to lingering concerns that the authorities may return to widespread capital controls if the economy worsens.

The authorities have taken steps, such as through the implementation of the recommendations of the Code on Corporate Governance, to address governance issues. We encourage the authorities to apply these principles evenly, including in high-profile cases, to demonstrate to investors that these rules will apply to all firms equally. The staff update suggests that the authorities are taking steps in the right direction here. If this continues, it will help encourage FDI and cushion the impact of slowing exports on the economy.

On fiscal issues, we reiterate the comments made last year that the authorities need to improve the monitoring and reporting of quasi-fiscal liabilities arising from institutions like the Infrastructure Development Fund, the Employees Provident Fund, and Khazanah. Greater oversight is needed to allow the authorities to calculate the size of their fiscal stimulus properly, as well as the longer-term issue of contingent debts. Greater transparency of these agencies—including in their operations in the stock market—would help ensure that public resources are used efficiently and reduce opportunities for insider-dealing.

Finally, we cannot avoid discussing the exchange rate regime. Mr. Low and Ms. Phang lay out the authorities' view in great detail in their statement. In addition, while it is correct that economic fundamentals are more important than the choice of exchange rate regime, we are more persuaded by the arguments by staff and in some of the preliminary statements. In particular, it seems clear that the staff is correct to note that there is a potential conflict between the goals of maintaining a peg, keeping interest rates low, and maintaining adequate reserves. Mr. Shaalan and Ms. Koranchelian describe these conflicts in their preliminary statement, and we concur with their position. We understand from Ms. Phang that the authorities are ready to consider policy changes if the exchange rate becomes misaligned, but we would argue that the time to consider action is before such a situation. It is easier to make adjustments before one faces more difficult economic circumstances. Thus, we encourage the authorities to consider changes to the exchange rate when circumstances allow, rather than run the risk of being forced to act in the future by a deteriorating market situation.

In conclusion, I would urge the authorities to re-think their position concerning publication of the staff report. In their statement, Mr. Low and Ms. Phang have highlighted some of the more negative comments from the Article IV (none of which, I might add, appeared to be inaccurate). But, there are also many positive comments that the authorities can cite. I quote two: "Efforts to adopt best practices of corporate governance have been impressive." And, "The authorities' efforts to conduct monetary policy increasingly through market-based instruments are welcome."

Ms. Phang noted that the authorities considered the airline industry to be an important and strategic one for Malaysia. They could, therefore, not allow Malaysia Airlines to collapse as the result of the actions of a few individuals, and consequently had to purchase it. Unfortunately, the owners of the airline would only agree to sell it at a price higher than the market price, and the authorities were left with little choice but to accept their offer. It was, therefore, unfair to refer to the government purchase of Malaysia Airlines as an example of cronyism, insider trading, or favoritism.

With regard to the exchange rate, the authorities were monitoring very closely all the developments and all of the indicators in the market, and were prepared to take action if, in their assessment, it was necessary, Ms. Phang remarked.

The authorities were not consenting to the publication of the staff report because they felt certain parts of it could be misinterpreted, which could have serious consequences.

Mr. Couillault made the following statement:

> First, let me thank the staff for its clear and precise presentation of the economic situation in Malaysia. In my view, it generally strikes the right balance between candidness and caution. After a strong recovery in 2000, Malaysia is now affected by the slowing down of the global economy and is suffering, in particular, from the strong deterioration in its activity involving electronics. Indeed, given the high openness of the economy and its strong specialization in electronics, the reversal of the cycle has a strong impact on output growth. June figures, both for exports and industrial output, reflect an accentuation of the slowing down process. Nevertheless, the situation has remained manageable so far.
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> The authorities have reacted aggressively to the economic evolution, and have taken significant countercyclical measures that should help to cushion the negative impact of the deterioration of the international environment. As the staff rightly notes in Box 2, Malaysia is in a stronger situation now to absorb external shocks than in 1997, both in terms of macroeconomic fundamentals and macroprudential indicators. In particular, the level of reserves is three times higher than the short-term debt and two and a half times that of the monetary base. But, the staff recalls that a combination of a fixed exchange rate with fiscal deficits and capital outflows may pave the way for a financial crisis, and encourages the authorities to move toward a more flexible regime as soon as circumstances permit
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> Last year we expressed the view that at that time there was no compelling reason why the authorities should act forcefully. One year later, we still have no strong views on this issue. It is true that most of Malaysia's competitors have adopted a more flexible approach of exchange rate management, but there is no clear sign of a strong overvaluation of the ringgit and, as the staff rightly notes, the short-term risks subsided in recent months. In particular, the narrowing of interest rate differentials with the U.S. should help limit capital outflows. Besides, the current account remains strong, and if exports have declined recently, such an evolution is not a Malaysian peculiarity. Furthermore, this decline has been accompanied by a decrease in imports more pronounced than in other countries. As the vulnerability analysis does not show a major risk of crisis, the authorities have some room for maneuver. Given the strong defense of the peg in Mr. Low and Ms. Phang's statement, we can only be impressed by the authorities' determination to defend their peg.
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> This being said, we share the staff's views that the authorities should monitor carefully the evolution of the external account and should be ready to

adapt macroeconomic policies and potentially increase interest rates, if needed, to support the peg. On this point, I am very close to Mr. Wijnholds. We understand the authorities' argument that such a move would encompass some negative impacts on the economy, notably through the balance sheet of the financial and corporate sectors. However, given the constraints imposed by a peg, the array of choices appears limited. I think there is kind of a conflict here, and I am wondering what is the authorities' stance should there be a deterioration of the current account and some capital outflows.

On fiscal policy, we welcome the authorities' intention to commence fiscal consolidation next year. I think it is time to send a positive signal to markets that fiscal sustainability is not questioned over the medium term. Given the slowing down of the economy, the authorities have reacted by taking countercyclical measures, which have led to an increase in the fiscal deficit to a high level in comparison with the Malaysian standard for the third year in a row. While there is also a general tendency of governments to privatize the national airlines, the acquisition of Malaysia Airlines sends an ambiguous message to the markets, especially when there is a need to improve governance practices in order to continue to attract FDI.

The results achieved so far in terms of structural policies have nevertheless been relatively satisfactory. In the financial sector we welcome the preparation of the capital markets master plan and the financial sector master plan. The implementation of reforms has resulted in a stronger financial system, and Malaysia should be in a situation to weather relatively well the slowing down of the economy. However, the level of nonperforming loans remains relatively high, and there is a need to maintain a high level of supervision. The results achieved in terms of debt restructuring and bank recapitalization are encouraging, and we have to recognize that the level of the recovery rate at 60 percent, even though partial, is impressive. Given the ambition of the authorities to develop the Malaysian capital markets and to make it the preferred fundraising center for national companies, we believe that becoming a candidate for an FSAP would be fruitful.

The results in terms of corporate restructuring have been mixed, and more progress needs to be achieved in the restructuring of conglomerates. We welcome the efforts engaged in promoting corporate governance and, in particular, the implementation of the recommendations of the high-level finance committee. We encourage the authorities in pursuing fair implementation of the new code of governance. We also welcome the prolongation of the CDRC and its recent restructuring, which, in our view, should help in dealing with the difficult cases still pending.

After adjourning at 1:00 p.m., the meeting reconvened at 2:30 p.m.

Mr. Chelsky made the following statement:

Like Mr. Shaalan and Ms. Koranchelian, I am in general agreement with the staff's analysis and conclusions. I can also associate myself with much of what Mr. Baukol as said, particularly his observation that, while there is much on which to commend the authorities, there are potential weakness that need to be addressed. In particular, I would echo staff's caution about the risks inherent in potentially inconsistent macroeconomic policies, particularly in the context of an external environment characterized by large and fickle capital flows.

I would also like to commend staff for the emphasis they have placed in this consultation on vulnerability assessment and the prevention of future crises. Their forward-looking analysis, which of necessity involves hypothetical reasoning, is both appropriate and timely. Indeed, if the international community's experience in the Asian crisis taught us anything, it is that the appropriateness of macroeconomic policies generally—and exchange rate policies in particular—needs to be assessed in forward-looking manner rather than in a static or backward-looking way. This is particularly important as the international monetary and financial system continues to evolve rapidly. I therefore see no inconsistency between acknowledging that the current level of the exchange rate is not misaligned and expressing concern with the potential for disequilibria to emerge in future.

While I found the arguments contained in the statement by Mr. Low and Ms. Phang interesting, I must admit to disappointment with what I consider to be an unfair and unnecessarily defensive reading of the staff report. I do not believe it is fair or constructive to assert that "staff have difficulty in grasping the point that the policy mix for an individual country should take into account its specific circumstances." Nor do I believe that the authorities are justified in dismissing staff's analysis by suggesting that it is based on "the standard approach of flexible exchange rates as the optimum arrangement for all countries at all times." Such a statement is not just a sweeping generalization, but an inaccurate one as well.

The authorities would be wise to take note of the fact that, while past failures of fixed exchange rates in many countries (especially in East and South East Asia) may have largely been due to inconsistent fundamentals, hubris among key decision makers and the failure to adapt to permanent changes in international capital markets also played important roles.

It strikes me that much of the authorities' defense of a peg to the U.S. dollar is backward looking—if not somewhat nostalgic. It is an over-simplification to believe that a country's choice of exchange rate regime should be made independent of an assessment of the external environment—even when the chosen regime can be maintained with supposedly consistent macroeconomic and financial policies. Decisions on the exchange rate regime should also incorporate consideration of the costs of maintaining "consistent" policies. This must be done, not just in a static sense, but dynamically, and should involve an assessment of the vulnerabilities that may result.

Even when taking into account the significance of the U.S. dollar to Malaysia's external debt and trade, the importance of other currencies to the Malaysian economy—most of which are now maintained with flexibility—suggests that a strict peg to the US dollar is likely not optimal in the longer run. This is true even if CGER analysis shows that, at a single point in time, the exchange rate is near its equilibrium. The staff uses CGER estimates with caution, particularly in the context of developing countries. I am not convinced—as suggested in the statement—that they have based their view "mainly on CGER estimations." I would similarly suggest that the authorities not give CGER estimates too much weight in defending the current regime.

This is not to say that the authorities should move immediately to a free float, or that a free float is optimal for their needs. Indeed, neither staff nor I make this argument. On the issue of timing, and as Mr. Wijnholds suggests, the authorities are right to pose difficult questions about the appropriateness of a near term change in the exchange rate regime. However, it is difficult to greet silence on this point on the part of the authorities with too much comfort even given the limits to transparency to which Ms. Phang legitimately points.

On the question of what the optimal exchange rate should be, it is not the case that the choice is between the status quo and a free float. Indeed, there are a multitude of intermediate regimes that could provide the country with the stability it desires, while sheltering it significantly from external shocks and global currency realignments. A peg to a basket of currencies reflecting the composition of Malaysia's trade and capital flows would certainly be an improvement over the current peg and would likely prove more robust and credible in the longer run. The authorities need not look much beyond Singapore for an example of how well this can work.

Another concern I have with the statement is the "creative" manner in which data is sometimes used to challenge staff's analysis. For example, to suggest that "reserves have returned to their upward trend" is a bit of a stretch. Rather, following a lengthy and significant decline in reserves, Malaysia has experienced a mere 4 months of modest reserve increases. This is hardly the resumption of an upward trend, particularly when compared with earlier peaks. Further, the statement quotes a figure of 5.8 times as the reserve coverage of short-term debt. This is in contrast to staff's much lower estimate of around three times. Quite rightly, the staff is basing its figure on remaining maturities. The authorities, I believe are using original maturities – a much less relevant analytical construct. I also note the different estimates of reserve coverage of imports. It would be helpful from the standpoint of transparency had the statement used the more widely accepted measures—or else have been clearer about the nature of the differences with staff.

I found there to be somewhat of an inconsistency between the statement's contention that "Malaysia's diversified economic base has helped to cushion the impact of the slowdown in external demand" and the assertion in the very next paragraph that "the Malaysian economy will continue to be subject to the vagaries of the global business cycle as trade accounts for more than 200 percent of GDP." The authorities cannot have it both ways. I believe that the second statement is more accurate, particularly given the data in Table 37 of the Statistical Appendix, which shows that electronics account for well over half of exports, including commodity exports.

Turning to fiscal policy, and for the sake of brevity, I will not repeat staff's concerns about the recent acquisition by the authorities of privatized assets, including Malaysian Airlines. Suffice it to say that I believe their concerns are legitimate and—as implied by paragraph 21 of the statement—do have potential significant budgetary consequences. Moreover, the fact that the government felt it necessary to acquire some of these assets in order to ensure the viability of these "strategic" industries implies a lack of confidence by the authorities in the ability of the private sector to undertake the necessary restructuring. Were this the case, it does not reassure one with respect to public-sector support for an environment conducive to private-sector activity.

Lastly, I was disturbed by the justification the statement gives for why the authorities do not want to public this staff report. Obviously the authorities have the right not to publish and this is a right we respect. In fact, we can see how—on the basis of the market sensitivity of the extensive discussion of the exchange rate regime, the authorities could understandably choose not to publish it. However, this is not the nature of the justification they have given for not publishing. Rather, they attacked the staff report for being "alarmist," "sweeping" and "flawed." I do not believe this is a fair or accurate description of the staff report. Indeed, as suggested by Mr. Baukol, the examples put forward by the authorities to illustrate what is wrong with the staff report are either factual, logical in their construction, or legitimate points of view on the direction of economic policy. Malaysia is frequently characterized by an "insider" system of corporate governance. The combination of an exchange rate peg with low interest rates and an expansionary fiscal policy could conceivably become inconsistent. (I note that staff did not say "will become inconsistent"). Pressures on the ringgit could resume for the reasons given. I could go on, but believe the point has been made. Paradoxically, the authorities' rational for not publishing the staff report implies an underlying fear that if the facts about economic management and conditions became publicly known, this would be seriously destabilizing. Rather, Malaysia's

> underlying fundamentals—at least for the present—remain strong, suggesting that their extreme sensitivity is exaggerated and not wholly justified.

Mr. Daïri noted that authorities had every right not to consent to publish the staff report, and Directors should not second-guess their decisions.

Mr. Chelsky replied that he was not second-guessing the authorities. The arguments they had put forward to justify their decision were, however, not convincing.

Mr. Toyama made the following statement:

> The strong growth of the Malaysian economy with electronic exports as its driving force has been hit hard by the slowdown in the world economy, in particular that of the United States as a large consumer of its exports. In addition, as the currencies of neighboring countries that have moved to a flexible exchange rate are weakening, more pressure is mounting on the foreign reserves, heightening external vulnerability. The authorities' present task is to undertake the delicate task of adopting expansionary fiscal measures to underpin economic activity in order to arrest the economic plunge, while at the same time steering monetary policy so as not to overkill the real economy; all this while simultaneously being mindful of the effects of monetary policy on the foreign exchange market.
>
> The authorities claim that the present policy mix they intend to pursue—fiscal and monetary policy both being accommodating—under the current exchange regime is consistent. Although we support the general stance of their fiscal policy, on monetary policy I am more skeptical about the authorities' stance, being mindful of the time lag for its effects to appear, but also of the risks that a loosened monetary policy can pose for the exchange rate regime.
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> On fiscal policy, the need for fiscal stimulus to boost the domestic economy in order to limit the secondary effects of the decline in exports on the domestic economy is reasonable, and we can support such an expansionary stance in the 2001 budget. In particular, we welcome expenditures for infrastructure development as well as measures to facilitate the transfer to a knowledge-based economy. That said, it will be important to assure that these expenditures are effectively allocated to projects that indeed will contribute to enhancing productivity in this economy. For example, in the case of infrastructure development, if a project that had been postponed during the height of the Asian crisis is going to be taken up as part of an accelerated measure, it would be particularly important to see how the resumption of previously 'low priority' projects could be justified under the present circumstances.

In any case, we must keep in mind that stimulus to the domestic economy may not be sufficient to make up for the decline stemming from the drop in external demand, considering the extent of the economy's dependence on exports. For example, measures to boost consumer demand, such as lowering the voluntary contribution to pension funds, may not reap the expected increases in consumer demand, as when confidence in the future is shaky, one may tend to save rather than consume any additional personal revenue. Also, in the case of measures to enhance bank lending, this may present an added burden to a sector still undergoing restructuring, and therefore may not progress as expected. In Box 2, the staff has a more cautious estimate than the authorities on the effects of the March preemptive supplementary measures, and we share the staff's view on this point. Moreover, it will be increasingly necessary to take into consideration the effects of what a continuous deficit could have on the size of the debt and on debt sustainability. In this connection, as the staff mentions, it will be necessary to compile comprehensive data including the debt of non-financial public enterprises and strengthen their monitoring. Even for a country such as Malaysia, which has traditionally had a high savings rate and a prudential fiscal stance, such measures will assist in enhancing economic confidence.

In a situation where it is highly likely that boosting domestic demand will not compensate for the slowdown in growth resulting from a decline in exports, the authorities have some basis in wishing to support economic activity through an accommodative monetary policy. However, the biggest risk facing the Malaysian economy is the possibility that neighboring countries' conditions could deteriorate substantially, followed subsequently by a depreciation of their currencies, which would effectively push up the value of the ringgit and add pressure for its devaluation. Even though such external pressures may seem to have receded for the time being, there is the distinct possibility that such pressures will reappear. We believe that over the medium-term horizon, increasing the flexibility of the exchange rate will serve the needs of the Malaysian economy better. At the same time, we agree that at such a critical juncture, it may not be appropriate to move to a flexible exchange rate immediately. Taking into account the risk just mentioned, it seems only prudent to have a cautious stance in relaxing the monetary stance, in case intervention or an inadequate supply of reserves is not enough to ward off pressures to sell the ringgit.

The need to appropriately adjust the exchange rate and to put in place an effective regime will also be particularly important for attracting foreign direct investment to Malaysia. Although there does not seem to be a substantial drop in the level of FDI at the moment, in light of future competition with other countries in the region, it will be all the more important to shed light on the appropriate level of the ringgit.

Concerning the banking sector, it is reassuring to see the average capital adequacy ratio is above 12 percent and the percentage of nonperforming loans had declined from a level of above 20 percent to around 15 percent, although according to the most recent staff supplement the outlook seems a bit gloomier. It is encouraging to see bank mergers progressing generally as scheduled. It is this restructuring of the banking sector that will allow room for banks to provide credit appropriately to the corporate sector, which will facilitate the restructuring of this sector as well. In this situation the authorities' policy of setting a credit growth target of 8 percent for each bank would seem to be contrary to enhancing efficiency and could lead to a misallocation of resources, especially when there already seems to be limited growth in loan amounts outstanding in the manufacturing sector. Further on the corporate sector, taking into consideration the need for further restructuring to enhance efficiency, and given the forthcoming movement toward liberalization, it will be important to address the problem of labor force rigidity. The staff report mentions some areas where measures are being taken in this regard, and we encourage the authorities to further their efforts on this front.

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

Mr. Joicey made the following statement:

Let me join other Directors in thanking the staff for this very well-written report. I broadly share the staff appraisal, and agree with the comments made so far.

On the economic outlook, while we recognize Malaysia's strong economic growth in 2000, we nevertheless think that the staff report and Mr. Low and Ms. Phang's statement draw attention to a recent weakening of economic activity with significant downside risks owing to the prolonged downturn in the global economy. Although the recent growth figures were better than some have feared, there has nevertheless been a significant fall in the electronics sector, which, as other Directors have noted, accounts for more than 50 percent of exports. We would welcome any comments from the staff on that. Nevertheless, the traditional indicators of external vulnerability remain strong, and we join other Directors in welcoming the steps Malaysia has taken to reduce its vulnerability.

Turning to fiscal policy, we would agree with the staff and the authorities that an expansionary fiscal policy seems appropriate in response to the downturn. However, the government has reportedly spent only around 7 percent of the additional spending allocated in the March budget. It would be helpful to have the staff's comments on that, and also on Ms. Phang's comments on the authorities' plan to increase the rate of spending. I note that strong fundamentals give Malaysia a degree of flexibility to respond to the current downturn and that it is better placed than it was in 1997. However, the fiscal deficit and the high level of public debt place constraints on fiscal policy. In terms of the deficit, we are interested in the staff's comments on whether the recent growth figures have had any impact or projected impact on the deficit this year, and what will be the knock-on effects of lower than expected growth.

Like a number of other countries, which we discussed before this summer, Malaysia faces the challenge of providing support for economic activity with a commitment to fiscal consolidation. We agree with the staff that fiscal consolidation should begin as soon as growth recovers. Moreover, it is important to note that, given the current turbulence in some emerging markets, it is important to recognize that the high fiscal deficit could undermine investor confidence. We also wonder whether the staff and the authorities have discussed what would be an appropriate response if the downturn, particularly in the electronics sector, proves more prolonged than expected.

On the exchange rate, we would agree with the staff report that, in the medium term, a more flexible exchange rate would give the authorities greater flexibility to respond to external shocks. But, at the same time, we recognize the authorities' clear desire and commitment to maintain the current peg. Nevertheless, we believe it is important to discuss and address the risks and policy dilemmas associated with this approach, and we think the staff report is helpful in this respect.

The substantial capital outflows in the first half of 2001 are a cause for concern. While they have eased recently, there is a risk of renewed pressure if other regional currencies weaken or confidence in emerging markets is further undermined. We welcome the assurances that Ms. Phang has given us today that the government is monitoring the situation closely and is thinking about contingencies. However, Ms. Phang expresses concern over the staff's suggestion to be prepared to raise interest rates in the event of further outflows. This begs the question of what would the authorities do in the event of a shock and renewed outflows, and what options are left open to them.

On a more positive note, we very much welcome the authorities' abolition of the remaining capital controls on portfolio investments.

Corporate restructuring clearly remains a key priority. We very much welcome the recent policy announcements suggesting that the government is determined to press ahead with corporate and financial sector restructuring. We would add one note of caution that banks should be prepared to get a cut. This could increase significantly the ratio of nonperforming loans at a time when weaknesses in the economy and the corporate sector may already be putting further pressure on banks. On nonperforming loans, we would appreciate comments from the staff or the authorities on the substantial differences between the figures quoted in the staff report and in Mr. Low and Ms. Phang's statement.

While we welcome that the government has taken on corporate governance, and welcome the comments of Ms. Phang today, like others, we do have some concerns whether government acquisition of Malaysia Airlines was consistent with the new rules. We also share the concern that the credit growth target of 8 percent could interfere with the sufficient allocation of resources and impede banks' ability to manage risk. We also encourage participation in an FSAP review, which would demonstrate the substantial progress the authorities have made and would help identify priorities for further work.

Ms. Bonomo made the following statement:

I thank staff for this interesting set of papers and its clear-cut appraisal of Malaysian economic policies. Malaysia has had a swift recovery after the Asian crises. Economic management has been very diligent and successful and progress with structural reforms was good. In the current environment, however, the authorities should be cautious to keep internal and external policies consistent. Notwithstanding the interesting comments by Mr. Low and Ms. Phang in their statement, I think as staff and other Directors that such consistency would be easier attained through a more flexible exchange rate.

The economic environment has changed very much since the last Article IV consultation: Malaysia, like the other countries in the region, has to cope with a marked slowdown of the global economy. In this situation, an expansionary monetary policy is generally called for, but Malaysia is constrained by its choice of exchange rate regime. I fully share the staff's concerns that the envisaged monetary policy, together with a strongly expansionary fiscal policy might become inconsistent with the current fixed exchange rate and could raise investors' uneasiness. If the authorities are fully convinced that the current exchange rate regime should be maintained in the near future, they should also be ready to raise interest rates if necessary and should give a clear signal of this readiness to markets. I would be extremely cautious in explaining recent reserve outflows with particular circumstances. My preferred option however, would be to think of ways how Malaysia could introduce a more flexible exchange rate regime. This seems to provide more room to cope with the uncertainties ahead. I welcome that the authorities are reviewing all the options and are monitoring developments closely. I hope they will be able to make a strategic move at the right time. Currently, external pressures have eased. This signifies that the costs of the peg are lower, because interest rates can be kept low. However, the fact that pressures have eased would also make it more appropriate to envisage changes to the regime, since such changes should ideally take place when the country is in a position of strength.

Briefly turning to credit policies, I would prefer reliance on market-based instruments to the authorities' policy of setting a minimum credit growth target for banks. As staff points out, such a policy bears the danger of an inefficient allocation of resources. Further, it may run counter to the authorities efforts to foster better credit risk management in banks. I am not fully comforted by the authorities' assurances that the lower limit of 8 percent growth will be flexibly implemented. Even flexible arrangements could distort capital allocation, and could lead to arbitrary decisions by the administration and poor governance. Ms. Phang says that the banks will not be punished if they don't reach the goal, but may be this message is not so clear to the banks.

On fiscal policy, given the current slack in the economy the authorities' expansionary policy seems appropriate. Nonetheless, I share the staff's uneasiness with the growing level of debt relative to GDP. In this respect I welcome the authorities' concrete plans for fiscal consolidation for the years 2002 to 2004. As to the concrete allocation of the additional fiscal expenditures, the choice of expenditures with low direct import content is commendable. However, other elements are more problematic. First, I agree with staff that acquiring infrastructure projects in financial trouble is not a good way to go. In particular, I was struck by the authorities' efforts to purchase an important share in Malaysia Airlines while efforts generally go in the opposite direction elsewhere in the world. Second, I would not generally recommend a civil service wage hike to boost private consumption (paragraph 7). Could staff comment on the efficacy of this measure for demand stimulation?

As structural policies are concerned, Malaysia's progress in financial sector restructuring following the Asian crisis is commendable. This encompasses the good progress in the disposal of impaired assets by Danharta, the repayment of recapitalization funds to Danamodal and the success of the Corporate Debt Restructuring Agency in resolving corporate debt. Furthermore, the authorities have made efforts to improve credit risk management and put in place a new regulatory framework to monitor loan quality. On the other hand, progress was rather slow with regard to corporate operational restructuring. What is also left is to work on an improved deposit insurance scheme that does not offer the current blanket guarantee. With these reforms in place, the authorities should then be able to move toward a more liberalized interest rate setting process.

Finally, I warmly welcome the authorities' initiative to promote good corporate governance, including more comprehensive disclosure standards and the protection of minority shareholders through appropriate regulations and guidelines. The contribution in the selected issues paper highlights the potential benefits these efforts bear. I share staff's view that not only the issuing of regulations, but also their evenhanded application would be important.

Mr. Garner made the following statement:

We would like to thank the staff for a well-written set of papers on Malaysia and Mr. Low and Ms. Phang for their comprehensive statement. Following the crisis in 1997–98, Malaysia economy has performed well, achieving during 2000 a high real GDP growth of 8.3 percent as a result of sound macroeconomic policies, low inflation and strong exports growth. However, during the first quarter of 2001 Malaysia's growth has been lower than expected due to the slowdown in the U.S. and Japan economies, as well as a decrease in the global demand of electronic components.

In this context, there are many issues that may be addressed, but we will focus mainly in two of the aspects that have been presented for discussion.

Regarding exchange rate policy, we agree with the views expressed by the authorities that strong underlying economic fundamentals, low inflation, strong current account, low external debt, and a solid reserve position are adequate elements to support the peg exchange rate policy that has been conducted by the Malaysian government. We concur with Mr. Rustomjee that with the current global slowdown and in a region where countries' exports tend to be similar and directed to the same markets, moving to a flexible exchange rate could result in a competitive devaluation within the region.

Nevertheless, we cannot rule out that the ringgit show a certain level of appreciation that is affecting export performance and competitiveness. We are pleased to know that the authorities are monitoring closely this situation and continually reviewing the risks and benefits of all available policy options in order to prepare for any eventuality, as expressed by Mr. Low and Ms. Phang.

In the fiscal front, we agree with the staff and authorities that in an environment of excess domestic capacity, a strong fiscal stimulus will help to counteract the decline in the country's economic growth. This policy is most welcome when the additional spending is used in education and social services, as this will not imply pressures on the external account. At the same time, we encourage the authorities to pursue with the fiscal consolidation process in order to be better prepared to face any possible external shocks.

Finally, we commend the Malaysian authorities for the efforts made to reinforce the financial sector and capital markets and to improve corporate governance, as these elements may strengthen investor confidence and further reduce potential vulnerability in the financial system. With these remarks, we wish the authorities continuous success in their future challenging tasks.

Mr. Bossone made the following statement:

We broadly support the thrust of the staff report, and I would like to associate this Chair with the remarks made by other Executive Directors in recognition of the staff's high quality analysis. Our concern is on Malaysia's policy strategy as we look beyond the short term, and consider the overall consistency of the strategy with the country's objective to develop into an open and market-based economy.

The coexistence of a currency peg with capital controls and limited banking sector competition has so far allowed monetary policy to keep interbank rates low, while permitting banks to benefit from large interest rate spreads and a stable exchange rate. To be sure, financial restraints (in the form of interest rate ceilings, lending targets, and administrative and capital controls) can be defended as heterodox instruments to protect bank franchise through rent creation, at a time when the financial sector undergoes liberalization and regulatory reforms. (I may recall recent World Bank research in this area and, in particular, the extensive work done or promoted by Joe Stiglitz on financial restraints.)

Yet, even though restraints can be successful in a transition stage, they are unsustainable over the longer term and may even work against the objectives they were originally intended to achieve. At some point, the economy must face outside competition without resorting to controls, domestic financial institutions must be capable of standing on their own, and macroeconomic policies must be geared to support financial stability, if the authorities want to build up full credibility and if the economy is to stimulate enough and efficient capital accumulation. There is no alternative to this policy wisdom, especially as Malaysia intends to develop into a knowledge-based open economy:  capital control, and more in general financial restrains, should not only be looked at in the context of smoothing short-term output variability, but also with respect to their long-term impact, especially via artificial rent-creation, protected interests, distorted competition and resource allocation.

We would like to emphasize three aspects brought up by the staff analysis. First, we agree with the staff that there is a prospective consistency problem in the current macroeconomic policy mix. Although we do not go as far as supporting the idea of a floating exchange rate regime for Malaysia, we do note that if capital controls are removed, and if the country opts for retaining the currency peg, then monetary policy must be oriented to maintaining the peg, while fiscal policy must be placed on a medium-term sustainable path. The staff is correct, we think, in alerting that, at times of financial market turbulences, a credible commitment to maintaining an exchange rate peg may imply policies that weaken the cycle, as the staff reiterated in the first round of replies. This is a risk that the Malaysian authorities need to be aware of, as they intend to retain the currency peg. Using capital controls to preserve the independence of macro policy from the exchange-rate constraint is not an efficient long-term solution—and the authorities seem to recognize this.

Second, in the context of defining a domestic policy strategy that is consistent with the country's full financial integration with world markets, the use of the budget to acquire infrastructure in financial trouble may detract from the credibility that the authorities need to gain. It also adds uncertainty to the medium-term sustainability of fiscal policy and makes the economy more vulnerable to changes in market sentiment (as indeed it should).

Third and final, nowadays—and especially since the Asian financial crisis—a credible domestic policy strategy requires both a solid and dynamic financial sector, perceived to be capable of managing risks efficiently, and strong corporate governance rules ensuring that firms pursue long-term profitability. One could say that both these factors today are an integral part of the fundamentals that markets evaluate when assessing country creditworthiness. Although Malaysia has been making remarkable efforts in both respects, much remains to be done. We commend the staff study of corporate governance issues, although more research should go into identifying the nature of the relationships between banks and the corporate sector in Malaysia, the impact of such relationships on corporate governance, and their effect on firm efficiency. This would be a key topic to be covered under an FSAP. Unlike the Malaysian authorities, we believe that an FSAP would be most useful now that the financial sector reform process is in place, rather than when sufficient progress is deemed to have been achieved.

Mr. Daïri made the following statement:

We thank the staff for the well-written papers, and Mr. Low and Mr. Phang for their informative statement. Malaysia's economic recovery proceeded at a robust pace in 2000, with strong domestic demand underpinned by supportive macroeconomic policies. Rapid expansion of private consumption and strong investment growth reflected a renewed confidence in the economy. Maintaining economic stability with low rates of inflation and unemployment as well as the authorities' efforts at reducing poverty and strengthening social programs are commendable. Progress has also been made in the area of financial reforms, with particular focus on financial sector consolidation and restructuring, bank recapitalization, and strengthening of banking regulation and supervision.

Following the slower global economic growth, initial signs of slowdown in economic activity in Malaysia have emerged since late last year. Real GDP growth is expected to decline sharply on account of the economy's high dependence on electronics, which has been severely struck by the global slowdown. A prolonged slump in electronics demand will have important ramifications on investment and employment. The authorities were prompt in announcing a fiscal stimulus in March 2001 in order to mitigate the impact of these adverse developments on the economy. The program aims at increasing public spending and boosting private consumption and is expected to add 1–1.1 percent to GDP growth in the current year. Nevertheless, the program's success depends partly on the consumers' reaction to the proposed tax cut, outlined in Box 2 of the report, which is also a main source of divergence between the authorities' and the staff's estimates of the impact of the stimulus.

We agree with the authorities that, in view of the economic slack, the planned fiscal impulse will not jeopardize economic stability. Moreover, the additional expenditure—focusing mainly on infrastructure, housing, and education—should not put significant pressure on the external current account. However, the staff's concern about using public funds to acquire infrastructure projects in financial difficulty is well placed. Such acquisition would entail government's assumption of implicit contingent liabilities that will adversely affect the fiscal position, with negative implications for market confidence. In the case of the national airline, we encourage the authorities to divest the government's share after the company's restructuring and reorganization. We welcome the recent exercise by the Ministry of Finance in Self-Assessment of the Code of Good Practices on Fiscal Transparency, which should help in strengthening fiscal data.

Monetary policy has been supportive of economic growth by keeping the interest rates low while maintaining price stability. We agree that monetary policy should continue to pursue those objectives. The plan to use market-based instruments more actively in the conduct of monetary policy is welcome. This would help improve the effectiveness of monetary operations and deepen the domestic bond market. The adoption of prudential-based liquidity management framework is another welcome development that needs to be followed by allowing greater freedom to financial institutions in setting deposit and lending rates.

The monetary easing in the United States and the prospects of strengthening the regional currencies offer an opportunity to maintain the pegged regime as the pressure on ringgit and the need for adjusting interest rates will be reduced. We agree with the authorities that the choice of the exchange rate regime should be based on various indicators and more comprehensive cost and benefit considerations, and we do not see, at this juncture, the need for an early move toward a more flexible regime. Nevertheless, as the staff has pointed out, macroeconomic policies need to be consistent with the choice of the exchange regime. In this context, it is assuring to note that the authorities stand ready to take necessary actions in the event of severe external shocks, and that they have formulated contingency policies for this situation.

Trade liberalization continues to deepen with the aim of enhancing efficiency and growth, attracting foreign direct investment, and achieving trade diversification. The authorities are understandably cautious in opening the capital account. However, we welcome the complete removal of restrictions on the repatriation of portfolio investment.

The authorities have maintained the momentum of structural reforms that have impacted the economy favorably. The financial sector and capital market master plans, adopted recently, provide appropriate frameworks for improving the resilience and efficiency of the financial system and for the orderly and effective deregulation and liberalization of the capital markets. The authorities have rightly identified areas for further improvement and development in the financial sector, but need to set a more ambitious time goal for achieving their objectives. Major efforts have also been made in corporate sector reform with the adoption of internationally recognized best practices in corporate governance and in upgrading disclosure standards and protection of minority shareholders that should strengthen investor's confidence.

Ms. Vtyurina made the following statement:

As in the past, the discussion of the Malaysian economy appears to be quite dynamic and not without controversy. At the outset, we would like to acknowledge a very positive performance of the economy during the past year and commend the authorities for their skillful economic management. Having read with great interest a comprehensive statement and the staff papers, I would say that while I share the view that there is a general consensus on several policy fronts, significant disagreements between the staff and the authorities on the exchange rate policy are regrettable. Allow me to comment on this important issue before moving to other topics.

Frankly, as the authorities I am perplexed by the nature of the staff's and other Directors' strong advise on the exchange rate policy, in particular its stringency and applicability in this particular case. The fact that last year's projections of a gross under-valuation of the ringgit did not materialize and actually have completely reversed themselves, suggest that there are significant flaws in the model used to measure the equilibrium exchange rate. The staff claims, however, that last year, the authorities missed the window of opportunity in moving to a flexible exchange rate arrangement. Similarly, this time around the vagueness of the advice to move to such arrangement "as soon as circumstances permit" leave a lot of room for speculation on what these circumstances actually need to be. In this regard, like some of the Directors, I would argue that in the near future a proposed change to a flexible exchange rate can have very negative consequences on the economy with the already depressed growth and in the environment of a global downturn. Although there has been some buzz in the markets about the viability of the Malaysia's fixed exchange rate regime in the region of mostly floating exchange rates and in the international environment where fixed rates have again come under pressure, there is actually little expectation that Malaysia will have to abandon its peg mainly due to three reasons: continuing competitiveness which is evident from a strong trade account; a decline in interest rate differentials with the United States and a somewhat weaker U.S. dollar; and strong economic fundamentals compared to other countries with similar arrangements.

It is important to emphasize that from the long term perspective the staff does not see the ringgit to be significantly misaligned. In this case, a good old American saying "if it ain't broke, why fix it" seems appropriate. What is raising concerns about the competitiveness, capital outflows, and the consequences of a domestic slowdown are the recent developments in the region as well as in the world economy. If pressures on the exchange rate were to arise again and external vulnerabilities were to become significant, I agree with the staff that some rebalancing of a policy mix may be necessary.

In this regard, management of the interest rate policy also seems to be a topic of a heavy discussion. On the one hand, we see merit in the staff's advise to use interest rates as a policy tool in resisting potential pressures on the ringgit, on the other, we understand the authorities' argument that, especially in a recessionary domestic environment and a global interest rate easing, increase in interest rates will depress economic activity, worsen corporate balance sheets, and subsequently weaken banks' financial positions. In this vein, we are glad to see the authorities' readiness to take necessary actions in the event of a sharp external shock, and that contingency plans are in place. On the latter, as much as I am curious about what those are, I respect Ms. Phang's position on this matter.

On the issue of interest rate ceilings, we note the recent progress with banks starting to implement guidelines on credit risk management. We are also encouraged by the authorities' intention to remove the ceiling on lending rates and abolish the BLR as envisaged in the financial sector master plan.

On the fiscal policy, we continue to support the authorities' efforts to provide fiscal stimulus to the economy. We do have some apprehensions that this stimulus may not be sufficient to counter a significant economic slowdown. However, while supporting the procyclical approach to the fiscal policy chosen by the government, we would be cautious in supporting additional fiscal loosening. We encourage the authorities to maintain their decision to achieve a balanced budged within the three-year period. This should continue to help maintain positive investors' sentiment, which relies highly on their belief in the authorities' fiscal prudence.

Progress in structural reforms is commendable, especially the recent attempts to revive the corporate sector reform. We encourage the authorities to continue efforts on this front.

Finally, we are sympathetic to the authorities' decision not to publish the report since we agree that some of the analysis in the report could trigger a negative market reaction.

Mr. Alosaimi made the following statement:

The Malaysian authorities are to be commended for the economy's strong turnaround after the Asian crisis. Since late last year, however, external developments have led to a sharp weakening of growth in Malaysia. High exposure to information technology exports has clearly compounded the adverse effects of the sector's worldwide slump. It is thus a measure of the authorities' sustained policy prudence and the economy's increased resilience that growth is to continue in a reasonably stable macroeconomic environment. Indeed, as Mr. Low and Ms. Phang have noted in their informative statement, growth in the domestic demand-oriented sectors remained buoyant. The continued low inflation and the comfortable external position are also welcome. Nevertheless, the outlook is uncertain, especially in view of the weakened external environment.

Regarding exchange rate policy, I share the view that no particular regime is suitable universally. As the authorities have emphasized, the important point is not the degree of flexibility but whether the exchange rate policy is part of an overall policy package consistent with the economic and financial fundamentals. In the Malaysian context, the evidence of an impending unsustainability is not clear. Specifically, there is general agreement that the peg is reasonably aligned with partner countries from a medium-term perspective. The authorities are rightly concerned over possible increase in instability and the interest rate rise that may be necessary to limit excessive depreciation. The emphasis on the dangers of triggering competitive devaluations is also appropriate. In addition, the case for a policy shift clearly requires a basis stronger than just the tentative findings from a computable general equilibrium exercise. On balance, I therefore agree that the authorities' cautious approach to exchange rate flexibility has served the economy well and should be continued.

I share the general concern over the continued decline in reserves. The resulting increased vulnerability has been somewhat mitigated by the accompanying drop in exposure to short-term debt. The additional transitory circumstances that the authorities have indicated should also be taken into account. Nevertheless, the importance of preparations for further external shocks is especially acute in the current difficult environment. A close monitoring of the developments and readiness for action are crucial. In that regard, I welcome the provisioning for contingency plans as well as the regional arrangements that are in place for external financing.

On fiscal policy, I share the consensus in favor of the stimulus in the present conditions of excess capacity. The concentration of increased spending in priority sectors and areas with low external leakage is welcome. That said, the staff is right to highlight dangers of using public funds to acquire failing private infrastructure projects. Indeed, this also underscores the importance of ensuring that ownership switches, whether from public to private or vice versa, are allowed to proceed on grounds of increased economic efficiency. Here, I share staff's caution against any adverse fiscal and debt profile implications of the possible acquisition of additional privatized projects this year.

The staff and the authorities appear to have a considerable divergence of views on direction and content of monetary policy. Here, while I share the staff's stress on readiness to adjust policies to changing market realities, it is indeed important to have adequate evidence before the staff signals an impending adverse turn in market sentiment. The staff also needs to have greater sensitivity to local conditions than is evident from the casual reference in paragraph 47 to the effects of high interest rates and the traumatic output contraction of 1997–98.

Malaysia's well-sequenced and cautious approach to liberalization of capital markets has served the economy well and should be continued. Here, I welcome the further adoption of liberal policies including the elimination of the restrictions introduced in 1998 on repatriation of portfolio investments. While I endorse the staff's support for complete integration of Malaysia's financial system into the global market, the speed and timing of the action to that end are best left for the authorities to determine. Finally, I welcome the significant progress made in the area of financial sector consolidation and restructuring. I join staff to encourage early completion of the authorities' agenda on corporate reforms and attention to any moral hazard concerns when acquiring entities facing financial difficulties.

With these remarks, I wish the authorities further success.

Mr. Çakir made the following statement:

The staff and the authorities differ on several policy issues, such as the appropriate exchange rate regime. For Malaysia, such differences are not unusual. It seems fair to say that in the past, the policy choices of Malaysia's authorities have proven correct. I will limit my comments to a few issues that I deem particularly important.

As to the exchange rate, the authorities' argument is more convincing than the staff's, and indeed, the staff agrees that the present exchange rate regime is in line with most economic fundamentals. The informative statement of Mr. Low and Ms. Phang argues that since inflation is low, the current account in surplus, external debt small, and reserves comfortable, the peg must have been serving the economy well, and we agree with them that changing to a flexible exchange rate regime would have the drawback of introducing uncertainty and instability into the domestic financial markets, while any benefits would be offset by the increase in the costs of imports and external debt, and could easily lead to higher inflation.

Several Directors are fond of medical analogies, and for today at least I will join them. In arguing that the move to a flexible rate should take place when Malaysia is in relatively strong position, to avoid a more costly forced exit from the peg later on, the staff resembles a physician who urges his patient to undergo a preventive appendectomy to avoid the possibility of appendicitis later on. Of course there is nothing wrong with avoiding appendicitis, and of course one wants to trust his physician, but there have been cases where patients have died of complications after routine surgery, and we can understand the authorities' reluctance to take a needless risk.

Under a peg, monetary policy must be used as needed to defend the exchange rate with higher interest rates and limited judicious interventions. It is positive that the central bank will use more market-based instruments for liquidity management. Lending directives to commercial banks and central bank credits directed at specific sectors, albeit for limited amounts, should be phased out as the financial sector gains strengthen and becomes better equipped to make lending decisions without the government's assistance.

I would like to praise the authorities for the recent improvements in banking supervision. Making progress with corporate restructuring will be critical for promoting both for the soundness of banks and the confidence of the markets. Recent steps taken by the government to encourage mergers among smaller corporations and to address corporate governance generally, all help speed operational restructuring of corporations.

As to fiscal policy, we share the judgment of the authorities that a fiscal expansion in the present environment is an appropriate way of avoiding a sharper economic downturn. We will join the staff in warning the authorities to watch closely over developments in the current account and be ready to adjust the fiscal program if there arises a need to safeguard the foreign reserve position. In the same vein, we welcome the authorities' decision to commence a fiscal consolidation exercise starting next year.

On the recent takeover of the national airlines, such takeovers assume that government officials are able to manage corporations more efficiently than the private sector. The experience of many countries shows that this is often not the case. Nonetheless, this was the authorities' choice. I hope the government can succeed in promoting the service sector, and particularly the new airport as a regional hub.

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

Mr. Haupt made the following statement:

I thank the staff for its papers and Mr. Low and Ms. Phang for their illuminating statement. Like in the case of some other regional economies, Malaysia's impressive economic recovery of recent years has come to a rather abrupt halt. We concur with Staff that—considering the most recent reports on activity in the manufacturing sector—the growth projection of 2 percent for 2001 will be difficult to achieve. While the successful electronics export industry was an important driving force in the recovery from the 1998 downturn, the downsides to Malaysia's high reliance on this industry have now come to the fore. Furthermore, given the excess production capacities facing the IT-industry worldwide, it is difficult to say how rapidly the present slump will be overcome. This highlights the need to further bolster longer-term growth prospects by following through with the ongoing efforts to improve corporate governance, broaden the export base, loosen regulations on foreign equity ownership and contribute to a level playing field in the financial sector.

I broadly share the recommendations made in the report and shall only focus on a few points for emphasis:

On the difficult issue of exchange rate policy there is certainly no easy answer. I must say I have some sympathy, in principle, for the preference given by Staff to a more flexible regime. Malaysia's comparatively narrow export base and its being surrounded by economies with floating exchange rates suggest that the stabilizing effects of exchange rate flexibility, on balance, outweigh the problems caused by potential volatility of the exchange rate.

The more important issue, however, is the timing and the formulation of a good exit strategy. I agree that today's environment of uncertainty is not the best one for an abolishment of the dollar peg. In view of the manageable level of short-term external debt and other so far broadly satisfactory vulnerability indicators, there does not appear to be an immediate issue of exchange rate sustainability. However, given the less-than-certain prospects of a rapid recovery of the economy and the global outlook, there is, in my view, a risk that any interest rate measures and fiscal tightening in defense of the peg might become increasingly burdensome for the economy, thus fuelling possible pressures on foreign exchange reserves. In this connection, it is not fully clear to us, exactly which special factors—aside from manageable vulnerability indicators—should release Malaysia from the general requirement to support their exchange rate peg with consistent macroeconomic policies.

Against this background, we encourage the authorities to follow further developments of the reserve coverage and the real exchange rate closely and to revisit the option of a regime shift in a timely fashion should there be any sign of a build-up in balance-of-payments pressures. In this respect, careful preparation of such a move and active policy management in the period thereafter should indeed attenuate any concerns about a possible overshooting. We welcome Staff's recommendation for such a gradual change, which reflects a more differentiated view than a pure avocation of "corner solutions."

On fiscal policy, we agree that the present expansionary stance is appropriate for the time being, given the economic slowdown. In view of the strong rise in public debt, we support the intention to start fiscal consolidation next year and encourage the authorities to further enhance the efficiency of government spending. For example, restraint should be exercised with regard to the acquisition of entities with financial difficulties or public infrastructure projects of questionable productivity. Some of the recent activities, such as the purchase of Malaysia Airlines, seem to be neither very conducive to economic efficiency nor to the near-term goal of boosting aggregate demand and stimulating the economy.

Mr. Guetat made the following statement:

At this stage, I would like to make a few comments.

Malaysia has made remarkable progress in restructuring its economy following the Asian financial crisis. As a result, the country achieved macroeconomic stability with high growth, low inflation, and an improved external position. Although the global slowdown adversely affected exports in the electronic sector, the external current account remains in surplus and reserves are at adequate levels. Furthermore, sustained economic activity contributed to the smooth implementation of financial and corporate sector reforms aimed at making them more responsive to the country's development needs and improving risk management. Given the remaining vulnerabilities, I encourage the authorities to pursue the implementation of the master plans for the capital markets and financial sector, while accelerating the restructuring of the corporate sector.

On the exchange rate system, I support the view that it would not be appropriate under the current circumstances to move to a flexible exchange rate system. Like Mr. Zoccali and Mr. Maino as well as others, I believe that such a move would put further pressure on the ringgit and be detrimental to the stability of the domestic financial sector. Furthermore, I support the authorities' view to increase competitiveness through enhanced productivity, as explained by Mr. Low and Ms. Phang in their statement.

On monetary policy, I concur with Mr. Guinigundo that the authorities' judgment on monetary policy seems sound based on the factors listed in Mr. Low and Ms. Phang's statement. Also, like Mr. Rustomjee and others, I believe that low interest rates could be justified by the fact that inflation remains low and there is excess capacity. More generally, I support the authorities' effort to deepen financial intermediation through increased use of indirect instruments, as this will improve resource allocation in this sector.

To conclude, I support the authorities' reservations on the publication of the report, and I wish them every success in addressing Malaysia's challenges.

The staff representative from the Asia and Pacific Department (Ms. Meesook) made the following statement:

Mr. Joicey asked us to comment on the impact of the downturn in the electronics sector. As he noted, Malaysia is highly dependent on electronics exports, especially to the U.S.; electronics represent about 60 percent of total exports. Of this, about two-thirds would be related to semiconductors and products that are experiencing contracting demand, whereas the rest are related more to electrical products whose demand is still robust. If, there is roughly a decline of one quarter in electronics exports from the first category, and assuming that value-added in these products accounts for about 30 percent, this would translate to a decline of real GDP of 4 to 5 percent, and that is broadly consistent with the growth rate that we now project at about 1 to 2 percent. At the same time, I should mention that Malaysia has a few cushions. Its domestic demand, with a population of 23 million, is reasonably large. Its economy is diversified, with natural resources such as oil, gas, and agriculture. Malaysia also actively resorted to fiscal stimulus, which has a direct impact on the economy.

Related to that, he asked a question about the impact of the slow growth on the budget and the interaction between the budget and growth. The implementation of the fiscal stimulus is relatively slow at the beginning of the year, but it is being stepped up already. A slow start is normal; last year the pace was the same but when the year ended about 97 percent of development spending was carried out. This year, the machinery for accelerating project implementation that was set up last year has already been put in place. Revenue in the first half of the year was stronger than the trend, partly because of the catching up of the move to a same year assessment for corporate tax. Overall, however, given the traditional conservatism in projecting revenue, the staff believes that the revenue target will be broadly realized even with slower growth, whereas implementation on the expenditure side may be a little bit on the low side. Therefore, overall, the total deficit is likely to be somewhat lower than the 5.9 percent shown in the staff report, which leads to his question on the implications for fiscal policy of the growth slowdown.

If the real economy continues to be weak by the beginning of next year, but shows some responsiveness to this year's stimulus, it would be appropriate to consider possibly another year of fiscal expansion to make sure that Malaysia is well on a recovery path. The 2002 budget, therefore, could be formulated to be quite flexible, with additional stimulus to be added or withdrawn, as necessary. However, if this year's stimulus does not produce any response, continuing with a large budget deficit would be futile and solutions should be found elsewhere, either structural improvements or other efforts to improve the investor climate. In this situation, for example, a move from the peg may be warranted to reduce the burden of adjustment on fiscal policy.

Mr. Joicey also asked about the difference between the staff and the authorities' NPL data. The difference is because the definition used by the staff defines loans as nonperforming after three months or more, whereas I believe Ms. Phang was quoting ratios based on loans becoming nonperforming after six months or more. So, the staff is using a somewhat more conservative indicator. However, the trends are similar in both.

Ms. Bonomo asked whether raising civil service wages was an efficient way to raise domestic demand. Domestic demand will go up and the multiplier effects would kick in as civil servants will have higher purchasing power and if one assumes some positive marginal propensity to consume. In addition, the structure of civil service wages had not been raised for about 7 or 8 years, and they need to be adjusted periodically. As it turned out, the increase was timely in that the adjustment came during a time when domestic demand needed stimulating.

Ms. Phang made the following concluding statement:

Perhaps I should begin with some comments on some of the issues raised. Firs, on the points raised concerning FDI or foreign direct investment. Certainly, foreign direct investment has always been very important for Malaysia. Publications on Malaysia show clearly that growth was accelerated with the speeding up of FDI since the late 1980s. Hence, the government pays a lot of attention to FDI, and that is why measures were liberalized further. Box 1 attributes the decline in FDI since 1997 to weaker economic prospects and uncertainty about Malaysia's policy. We would like to say that the fact that there is a high level of investment applications and there have been several proposals to acquire some of the locally-owned businesses indicates that foreign investors continue to have confidence in the country's economic prospects. The actual inflow of FDI had remained significant, at US$3.8 billion in 2000. Net FDI was lower because of higher Malaysian investment overseas.

Second, on issues raised on capital controls, I would like to say that with the abolition of the 10 percent levy on profits repatriated early this year, the only remaining rule affecting movement of funds are the measures preventing the internationalization of the ringgit.

Third, with the completion of the consolidation of the domestic banking sector, there is currently no government-controlled banking institution. So the concern raised about the deposit insurance not having any impact because of the banks being mainly government-controlled does not hold true anymore. On the issue of government spending, Ms. Meesook has explained very well about government spending. However, it is not true that the pace of government expenditure is slower this year. In fact, development expenditure was faster in the year 2001. In the first half of this year, it was 35 percent of the allocation as opposed to 29 percent last year. But the overall deficit was lower, as pointed out by Ms. Meesook, because revenue was higher than anticipated.

I think those were the main issues raised by Directors. I will not repeat the other issues that I had touched on in my opening remarks. I must say that the whole discussion has been very lively and very interesting. I would like to thank all of the Directors who have shown so much understanding of the stance of the Malaysian government. At the same time, I would also like to assure you that I have taken note of all of the other comments made by the different chairs, and I will make sure that I convey them to my Malaysian authorities. Finally, I would like to reiterate that the staff has done very good work, and the staff representative has taken a lot of trouble to answer all of the questions very well; I thank them and the Board members.

The Acting Chairman (Mr. Fischer) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that, following a strong recovery in 2000, Malaysia's growth and exports had slowed sharply owing to the deteriorating global environment. Official reserves, however, have recently increased and continue to be adequate to cover Malaysia's modest short-term debt, while speculation against the ringgit has abated since end-May.

Directors had a broad-ranging discussion of Malaysia's exchange rate regime. They generally saw no immediate problem in maintaining the pegged exchange rate system in view of the assessment that the current level of the ringgit is not misaligned from its long-term equilibrium, and that economic fundamentals remain strong. Directors considered that maintaining consistent macroeconomic policies over time, combined with steadfast structural reforms, will be key to sustaining market confidence and helping Malaysia manage external and domestic risks, forestall excessive output contraction, and provide a basis for sustainable growth. Further diversification of the export base will make the economy more resilient to external shocks.

Directors recognized that the ringgit has appreciated since late 2000, and that there were pressures on Malaysia's international reserves early this year. Directors noted that, if the weakening of regional currencies recommenced or instability in emerging markets surfaced, the pressure on the ringgit and official reserves could be renewed, and that, should such an eventuality materialize, there would likely be a need to reassess the consistency between the macroeconomic policy stance and the exchange rate regime. In this connection, Directors welcomed the authorities' intention to monitor closely a variety of indicators and continually review the risks and benefits of all available policy options, with a view to maintaining a consistent policy mix. They also made several suggestions on policy options in the event market pressures emerge. A few Directors proposed that the authorities should consider the merit of introducing greater flexibility in the management of the exchange rate regime, but they agreed with others that the timing of such a move was an important issue, noting that any shift in the exchange regime at the prevailing highly uncertain global economic outlook and unsettled international financial markets could be destabilizing.

Directors also welcomed the recent removal of the remaining levy on profit repatriation of portfolio capital, and a few Directors urged the authorities not to resort to capital controls in the event of a deteriorating external position in the future.

Directors considered that fiscal expansion appears to be an appropriate policy stance in the current environment. Accordingly, they recognized that a temporary delay in fiscal consolidation is needed to avoid too sharp an economic slowdown and the risk of corporate and financial distress. Directors also noted that, given the nature of the spending, the fiscal expansion should not significantly weaken the balance of payments. Nevertheless, they cautioned that the authorities should monitor developments in the balance of payments on an ongoing basis and be prepared to exercise fiscal restraint in order to safeguard the external position.

Directors welcomed the authorities' plan to begin fiscal consolidation next year. This shift should help to reassure investors about Malaysia's fiscal sustainability in the medium term. A number of Directors expressed concern, however, about the use of public funds to acquire a commercial airline and the contingent liabilities that the government may be taking on in connection with a number of other privatized infrastructure projects, which could adversely affect the country's long-term growth prospects. They urged the government to extend support to these projects only as a last resort, and to identify clearly all potential public sector liabilities.

Directors welcomed the authorities' intention to rely more on market-based instruments in the conduct of monetary policy, and noted that efforts to develop the domestic bond market would facilitate this goal. They supported the adoption of a system of risk-based management by banks, which should permit the liberalization of Malaysia's interest rate structure, with banks setting deposit and lending rates more freely, without jeopardizing loan quality. Directors also welcomed the authorities' intention to apply the credit growth target flexibly, so as not to distort resource allocation decisions.

Directors supported the government's financial sector and capital markets master plans. If implemented effectively, the deregulation measures proposed in the plans would enhance the competitiveness and efficiency of the financial system, and lay the groundwork for eventual full integration into global financial markets. They encouraged the finalization of the proposed deposit insurance scheme in light of the moral hazard problems associated with the current blanket deposit guarantee. A number of Directors also encouraged the authorities to participate in the Financial Sector Assessment Program.

Directors welcomed Malaysia's efforts to adopt best practices of corporate governance and the recent steps taken to restructure operations of corporations. Some Directors were concerned about the remaining negative market sentiment owing to perceived poor corporate governance practices in a few high-profile cases. Directors considered that demonstrable progress in improving corporate governance will play an essential role in strengthening investor confidence and attracting foreign direct investment. They encouraged

> the authorities to accelerate corporate restructuring, and welcomed the authorities' plan to provide key data on progress with operational restructuring.
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> Directors considered that the overall quality of Malaysia's economic statistics is good. They welcomed the improvements that have been made in recent years to broaden data dissemination. Directors looked forward to seeing progress in the quality and timeliness of the balance of payments and external debt data, and urged the authorities to collect and publish comprehensive data on off-budget activities and contingent liabilities of the public sector.
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> It is expected that the next Article IV consultation with Malaysia will be held on the standard 12-month cycle.

## 3. ALGERIA—2001 ARTICLE IV CONSULTATION AND POST-PROGRAM MONITORING DISCUSSION

The Executive Directors considered the staff report for the 2001 Article IV consultation and post-program monitoring discussion with Algeria (EBS/01/130, 8/6/01). They also had before them a statistical appendix (SM/01/247, 8/6/01).

The staff representative from the Middle Eastern Department (Mr. Lazare) submitted the following statement:

> Since EBS/01/130 was issued, the staff has received the following information, which does not change the thrust of the staff appraisal:
>
> On August 20, 2001, President Bouteflika signed three ordinances aimed at (a) further reforming the external tariff; (b) introducing a new investment code; and (c) reforming the legal framework governing the management and privatization of state-owned enterprises. The ordinance on tariff reform, whose provisions will be effective on January 1, 2002, reduces the number of non-zero tariff rates from 4 to 3; the new rates are: 5 percent, 15 percent, and 30 percent. However, the classification of goods according to the three new tariff rates has not yet been published. The new investment code grants equal treatment to public and private investment, and places domestic and foreign investors on the same footing. It also reduces tax exemptions available for most investments, although additional tax exemptions can still be granted in some special geographic zones as well as to investments deemed to be of a particular interest to the Algerian economy. The ordinance on the management and privatization of state-owned enterprises eliminates the five public holdings which were responsible for exercising vis-à-vis state-owned enterprises the ownership rights and responsibilities on behalf of the state, reduces the number of institutions dealing with privatization, gives considerable flexibility to the government regarding all procedural aspects of

privatization, and eliminates restrictions on privatization which existed in some sectors.

Algérie Télécom, which will become the state-owned provider of telecommunication services in Algeria, was established as a stock company with the government as its single shareholder. These activities have so far not been separated from the post office services.

Effective September 1, 2001, Algeria's OPEC quota will be brought down to 741,000 barrels per day from 773,000 barrels per day (-4.1 percent). According to staff estimates, this should lower exports by about US$0.1 billion (0.5 percent) in 2001 and about US$0.3 billion (1.5 percent) in 2002.

Reflecting continued strong hydrocarbon revenues, gross foreign exchange reserves further increased to US$16.4 billion at end-July 2001, against US$11.9 billion at end-December 2000. Meanwhile, treasury deposits at the central bank increased by about DA 204 billion to reach DA 521 billion at end-July 2001 (about 12 percent of the projected 2001 GDP).

Owing mostly to falling fresh food prices, consumer prices decreased by 1.6 percent in July 2001. However, over the 12-month period ending in July 2001, the consumer price index increased by 6.3 percent.

During the first half of 2001, the real effective exchange rate of the Algerian dinar appreciated on average by 0.9 percent compared to its 2000 average level. The dinar depreciated in nominal terms against the dollar (from 75.3 dinars per U.S. dollar in December 2000 to 78.4 dinars per U.S. dollar in July 2001), while it slightly appreciated against the euro (from 70.0 dinars per euro in December 2000 to 68.6 dinars per euro in July 2001).

Mr. Daïri submitted the following statement:

My Algerian authorities thank the staff for their hard work and concur with the thrust of their appraisal. They value the continued dialogue and consultation with the Fund and are grateful to the Executive Board, management, and staff for their support and helpful advice and recommendations.

Background and Recent Economic Developments

Following the economic crisis of the early 1990s, Algeria has pursued a process of political and institutional reforms aimed at establishing the basis for a democratic society and the transformation of its centralized economy into a market economy. The firm implementation of a strong economic adjustment and reform program, supported by a flexible exchange rate policy and external financing, including from the IMF, led to a marked improvement in macroeconomic performance and financial stability. A wide-ranging agenda of structural reform was implemented over the period with particular focus on rehabilitating and restructuring the public enterprise sector, liberalizing prices, trade, and the exchange system, eliminating consumer subsidies, overhauling housing policies, and opening the banking sector to competition and strengthening its supervision. A large number of small public enterprises were closed down or privatized. Moreover, the legal infrastructure for privatizing the larger enterprises and for opening mining and telecommunications to private investment was established. Importantly, as indicated in Box 1 of the staff report, implementation of liberalization measures resulted in a rapid increase in private sector participation in the economic activity. These achievements were reinforced in 2000 when inflation was brought down close to zero and, with improved oil prices, the budget and the current account of the balance of payments posted large surpluses, equivalent to 10 percent and 17 percent of GDP, respectively. Debt indicators improved dramatically, and the international reserves reached the equivalent of one year of imports of goods and nonfactor services. On the fiscal side, revenues increased by 9 percentage points of GDP, while expenditure to GDP ratio declined, with a significant shift in its composition from current to capital spending. This, together with repayment of bank loans owed by Sonatrach, contributed to moderate monetary growth and price stability.

For 2001, GDP growth rate is projected to reach 3.8 percent. The external position is expected to strengthen further, with external reserves reaching 16 months of imports and debt indicators set to improve further. The authorities are determined to maintain a cautious monetary stance, geared toward safeguarding the gains achieved on the inflation front, and the managed float exchange rate regime.

Structural Reforms

The authorities have recently intensified their efforts to reinvigorate reforms. In addition to taking measures to modernize the monetary policy framework and the tax system, Box 4 of the staff report describes the progress made in preparing for the opening up of several key sectors to private sector participation, including electricity, hydrocarbons, telecommunication, and infrastructure. The competitive and open process leading to the successful sale of the second GSM license bodes well for future involvement of foreign investment in these key areas. The process of opening up the capital of the public airline company is underway. Additionally, a comprehensive tariff reform plan has been finalized with Fund technical assistance. Some key elements of the reform have been included in the supplementary finance law of 2001, including the elimination of the highly distortionary minimum duty values and the reduction in the maximum tariff rate to 40 percent.

The reform program has gained momentum with the adoption last week of three major ordinances. The first ordinance reorganizes the legislative and operational framework for privatization by making virtually all public enterprises open to privatization and streamlining of the decision-making process. The second unifies the investment incentives system and levels the playing field between private and public investors as well as between domestic and foreign investment. It also establishes transparent and streamlined procedures and creates a one-stop-shop for investors with regional branches. The third announces a new tariff structure, effective January 1, 2002, with three non-zero rates and a maximum rate of 30 percent. The authorities consider that the rationalized tariff would help accelerate negotiations on an association agreement with the European Union and WTO membership. They expect that these important reforms will provide a strong signal of their commitment to reform and will boost domestic and foreign investors' confidence with significant gains in efficiency and competitiveness.

The authorities have developed a three-pronged strategy to achieve a comprehensive restructuring of the banking sector. The strategy includes: (i) assumption by the Treasury of distressed debt owed by public enterprises amounting to some US$4 billion and recapitalization of three public banks to meet capital adequacy ratios and to enhance their attractiveness to foreign investors; (ii) opening of the capital of public banks to foreign participation: one of the six state banks is in advanced negotiations with a foreign partner to significantly open up its capital, and two are in the process of concluding a twinning agreement with foreign partners by end-2001; and (iii) modernization of the payments system with World Bank assistance.

The Recovery Program and Medium-Term Prospects

While macroeconomic stability has been achieved and institutional and structural reforms are undertaken to modernize and liberalize the national economy, growth has not been strong enough to address the underlying problems of the society, particularly in terms of employment, housing, social services, and living conditions. Addressing these pressing needs has hitherto been hindered by financial resource constraints and structural deficiencies. Now, however, the authorities are determined to utilize additional revenues from hydrocarbons to revitalize economic growth through elimination of infrastructure bottlenecks, upgrading human capital, and support to agriculture and to small- and medium-sized enterprises, which have a significant potential for job creation. Toward this end, the authorities announced in April 2001 a recovery plan for the period 2001–04. Designed to supplement and strengthen the authorities' structural reform program, the plan has three major objectives: poverty reduction, employment creation, and establishment of a regionally balanced domestic economy.

As estimated by the staff, the plan is expected to raise annual GDP growth rates to about 5 percent over the period 2002–04. Under current WEO oil price assumptions, the external sector will remain strong, with healthy levels of foreign reserves, and the budget will remain in surplus over the period. The authorities recognize that the budget projections may be vulnerable to declines in hydrocarbon prices, and, therefore, are determined to remain vigilant. To this end, they intend to implement the recovery plan in a flexible manner with due consideration to resource constraints and the need to maintain macroeconomic stability. In addition to strict selectivity and control of public expenditure, the authorities are committed to continue to improve budget transparency and to strengthen tax administration. While the staff's projections point to an uptake in inflation in 2001–02, the authorities expect that inflationary pressures would recede subsequently as a result of prudent financial policies.

Conclusion

Algeria has made considerable progress toward achieving macroeconomic stability, liberalization, and reform, attainment of external viability, reforming and liberalizing the economy, and enhancing its resilience to external shocks. The authorities, however, do not consider growth performance as satisfactory. They recognize that much remains to be done to pave the way for an accelerated and sustainable growth. To this end, they are committed to maintaining their prudent macroeconomic policy stance and consolidating the gains achieved so far. They are determined to pursue land, housing, and judicial reform, and to improve transparency and governance which, together with accelerated privatization efforts, further tax reforms, and greater private sector participation in the economy, will provide a firm foundation for a private sector-led growth that could address the major problems of the Algerian economy, particularly the high unemployment. They look forward to continued fruitful and frequent exchange of views with staff and to continue to benefit from the Fund's valuable technical assistance.

Mr. Padoan submitted the following statement:

Algeria has established a strong record of policy implementation over the recent past. The current macroeconomic scenario features modest growth and disinflation; following the rise in oil prices the international position is sound both in terms of balance of payments and external debt. Growth perspectives, however, remain sluggish and below potential. As the staff report makes clear, there seems to be ample room for improving growth potential and total factor productivity (TFP) through structural reform the pace of which should continue and in some cases be accelerated. Structural reforms are much more needed as supply-side led growth should take over the implementation of expansionary demand management policies in 2001–04. Otherwise either growth will decelerate or continued reliance on expansionary policy could jeopardize the sound fiscal and external position that Algeria has been able to achieve in recent years.

Algeria is now facing the challenge to complete its structural adjustment. It is a task involving several aspects: one is the transformation from an oil exporting economy to a manufacturing economy; a second one is further integration into world markets through trade liberalization; a third one is the completion of the privatization program. These aspects are obviously interrelated as progress in one area feeds back on the others, hopefully generating a self sustained virtuous process. It is, therefore, essential that the authorities maintain their effort in all areas of reform.

I welcome the adoption in 2000 of a stabilization fund to receive oil revenues in excess on budgeted values. In addition to avoiding undesirable loss of control in budget, it also protects the economy from possible, if remote, “Dutch disease” risks.

Especially if well managed, oil will remain a valuable resource for Algeria for the future to come. More dynamic and stable growth perspectives, however, rest on the transformation of the Algerian economy toward a manufacturing based structure. Key to this goal are the continuation of the privatization progress and the transition toward a more balanced and open trade system. The two processes are complementary as privatization increases the amount of resources channeled toward more dynamic sectors and a balanced tariff system minimizes distortions in the allocation of such resources.

Over the past decade the liberalization measures adopted by the authorities have significantly increased the private sector share in all sectors, with the exclusion of hydrocarbons. The acceleration of the program should contribute to enhancing the growth potential by further liberalization in sectors such as telecommunications, energy, and mining.

I am pleased to learn that authorities are working, with staff assistance, to set up a tariff reform based on the principles of neutrality, simplicity, and credibility, so as to overcome the previous arrangements’ shortcomings. As mentioned, such a new system will reinforce the growth enhancing effects of privatization and liberalization. It will also provide a sound basis for negotiations toward an association agreement with the EU and for negotiations toward membership in the WTO, the success of which I look forward to.

The ongoing structural transformation process will have to rely on an appropriate macroeconomic environment and policy stance.

In particular, I am concerned with the possible inflationary consequences of the ongoing processes. While disinflation has continued in 2000, core inflation has exceeded 3 percent in the spring of 2001. In addition, money-supply growth does seem a bit on the upside in the medium term, given expected nominal income growth. However, the increase in liquidity ratio could reflect a change in intermediation mechanisms. I would appreciate some comments from the staff on this issue.

My concern rests on evidence from other countries undergoing deep structural transformation such as Algeria. In such cases, prices tend to accelerate reflecting diverging productivity growth rates as productivity growth in sectors sheltered from competitive pressures tends to lag behind that of more dynamic open sectors. Price liberalization, which is a key component of the program, might add some tensions in this respect. So it is not current inflation that concerns me as much as possible inflationary tensions in the medium run. Authorities should be prepared to take this eventuality into consideration.

Also crucial in this respect is the evolution of the exchange rate. Authorities have to be congratulated for the way in which they have managed their float so far avoiding negative consequences on competitiveness as well as protecting the economy from external shocks. I share the staff recommendation to continue to manage the float in a flexible way and that measures be implemented to further liberalize the exchange system so as to increase the role of market forces and reduce the importance of the parallel market.

Mr. Kelkar submitted the following statement:

We thank the staff for an exhaustive report on Algeria's economy and Mr. Daïri for his detailed preliminary statement. We commend the Algerian authorities for improving the fiscal and external position through cautious policies and for their continued pursuit toward establishment of a democratic society. We note that the private sector has developed in short time and became a major force in non-hydrocarbon sector and contributed for increase in industrial production in a general adverse economic environment during the year 2000. However we are concerned at the continuing decline in the production of public industrial sector. The government's commitment to adjust their fiscal stance to the developments in the oil market is encouraging. We congratulate the authorities on launching a four-year recovery plan, with an investment of 525 billion Algerian dinars, to stimulate aggregate demand by addressing the issue of slow growth, poor social infrastructure, poverty reduction and continuation of structural reforms.

We hope that recovery plan with focus on labor intensive activities would strengthen non-hydrocarbon sector and create employment opportunities in the immediate future. We welcome the staff suggestion that the recovery plan should be implemented prudently over the medium term. In this context we hope the Algerian authorities would consider the staff suggestion to consult World Bank and other international financial institutions to review and strengthen the quality of expenditure and maximize return on their investment. We also agree with the staff that part of the recovery plan expenditure should be diverted to meet the social safety net schemes, which, in the long run, would cushion the social impact of public enterprise restructuring. However, as pointed out by the staff, the measures need to be combined with an acceleration of structural reforms that can intensify competition and strengthen the financial system so that the economy experiences sustained growth over a considerable period.

We also hope that the activities related to privatization, reforms of financial sector, customs tariff reform and liberalization of hydrocarbon sector would start bearing fruits soon. We are happy that the authorities have intensified efforts for modernizing the tax administration through simplified systems that raise efficiency. We agree with the staff suggestion that investment incentives need to be built into the tax laws. We are encouraged to note that the revenue has gone up from the 1999 level, with hydrocarbon sector contributing 30.2 percent of GDP, turning a deficit budget into surplus and helping the authorities to retire domestic debt early. However, this also underscores the vulnerability of the economy to oil-related external shocks and points to the need for reducing the heavy dependence of budget on revenue from a single product. We share the concern of the staff about a possible increase in import taxation and join the staff in encouraging the government to further reduce the maximum rate and not to use taxation to shield inefficient public enterprises from international competition. We are happy to note that the authorities are contemplating to rationalize the external tariff through budget law 2002. We note that the stabilization fund set up by the authorities to deposit excess revenue would help in transparent fiscal management. Nevertheless, we agree with the staff there is a need for saving part of the revenue to replace the depleting hydrocarbon reserves.

The reduced interest rates on the inter-bank market and the fall in refinancing cost indicate a relaxed monetary situation. We feel encouraged to know that the inter-bank money market was made more transparent through an effective flow of information. Broad money growth was contained despite an increase in foreign assets. We agree with the staff that the authorities adopt a cautious monetary stance and continue to devote their plans for the maintenance of low inflation. We encourage the authorities to pursue their efforts to modernize payments systems and explore seeking technical assistance from multilateral agencies. Though we are encouraged to learn that the authorities agreed to update the report on observance of standards and codes on banking supervision to reflect the amendments to central bank law, we are concerned that some of the amendments have a potential to weaken its independence. The rapid development of private banks is brining in new challenges of supervision, to which the authorities need to be more vigilant. The public sector banks are not healthy and it is a source of concern. Therefore, we encourage progress toward their restructuring.

In the external sector, the Algerian dinar remained stable. The current account surplus reached a level of 16.8 percent of GDP. Overall, the balance of payments position strengthened. The official reserves continued to rise, reaching the equivalent of 16 months of imports. With a stronger external sector, we hope the Algerian authorities would be in a position to achieve the objective set for development under the four-year recovery plan.

The classification of enterprises into three categories and prioritization in the privatization process is a right step. The legal infrastructure created by the authorities in furtherance of the privatization of larger enterprises and the opening of the mining and telecommunications sectors is welcome. The privatization process is expected to last for ten years. In the meantime, unless the existing public sector enterprises are given flexibility to operate in a market driven economy, it would be difficult for them to compete with out undermining workers' protection. The legal framework empowers the existing public enterprises to raise their productivity and improve competitiveness. We request the staff to provide more details on this.

We wish the Algerian authorities success in their policy endeavor.

Mr. Shaalan and Mrs. Farid submitted the following statement:

The Algerian authorities are to be commended for the remarkable progress made in economic stabilization and reform carried out between 1994 and 1998, in the midst a set of very difficult circumstances. After an extended period of negative growth and double digit inflation, the steadfast implementation of a comprehensive adjustment and reform program facilitated a resumption of output growth, brought inflation down markedly, and strengthened the balance of payments. Private sector activity also grew significantly as a result of the extensive economic liberalization undertaken, and is now contributing some 75 percent of value added in the nonhydrocarbon sector. Notwithstanding these developments, growth in the nonhydrocarbon sector slowed over 2000 and 2001, even as the strength of hydrocarbon production and robust international oil prices boosted fiscal revenues and led to a sharp turnaround in the fiscal and external balances. While part of the slowdown can be attributed to the severe drought that adversely affected cereal production, the lingering tensions due to the domestic security situation and the slow progress in structural reforms contributed to the weakness of private sector activity.

In the face of sluggish growth and very high unemployment, the authorities' adoption of an expansionary fiscal stance in 2001, through a reduction in the large fiscal surplus is appropriate. We are pleased to note that the fiscal stimulus contained in the "recovery plan" which covers 2001-2004, is intended as a complement to the structural reform plan passed by parliament in October 2000 rather than a substitute for it. By boosting demand, the fiscal expansion aims to trigger an acceleration in growth that would hopefully be sustained by a permanent pick up in private sector activity as further structural reforms are implemented. We are also reassured by the authorities' intention to tailor the recovery plan's implementation year by year to Algeria's evolving financial situation, since the budget remains vulnerable to developments in the oil market. At the same time, it is important that every effort be made to make sure that the proposed expansion in capital expenditures is allocated efficiently. Like the staff, we see a benefit of making use of World Bank expertise in the review of the planned capital expenditures. We also see merit in the staff's suggestion that some of the resources earmarked for capital expenditures be directed to an enlarged social safety net scheme. This would facilitate public enterprise restructuring, the acceleration of which would markedly improve the economic environment and promote domestic and foreign private sector investments. In this way, the recovery plan and the structural reform plan would reinforce each other.

As the staff rightly emphasizes, the sustainability of the projected expansion in growth resulting from the fiscal stimulus will depend on the progress to be achieved in the implementation of key structural reforms. In this regard, further market liberalization, which could contribute to export diversification, should be at the core of the reform agenda in view of the economy's high dependence on the hydrocarbon sector. Already, important steps have been taken by opening most sectors to private activity, including mining and telecommunications. Preparations are also underway to open the power and hydrocarbon sectors to private investment. The staff report also indicates that the authorities intend to proceed with the quick privatization and restructuring of state-owned enterprises, for which much of the preparatory work has already been completed. The most recent reform of the legal framework governing privatization should also facilitate this effort. In this connection, we commend the authorities for the recent adoption of the three major ordinances covering, in addition to privatization, the external tariff and the investment code. As noted by Mr. Daïri in his helpful preliminary statement, they provide a strong signal of the authorities' commitment to reform, and constitute an important step toward the achievement of a critical mass of structural reforms that would significantly improve prospects for private sector investments, including foreign direct investment.

In the financial sector, the rapid development of private banks over the past years should facilitate the provision of financing to the private sector. As the staff notes, the increase in private banks requires continued efforts directed at strengthening banking supervision, which the authorities are undertaking with the Fund's technical assistance. With regard to the state-owned banks, whose assets still exceed 90 percent of total bank assets, we welcome the authorities' decision to include measures toward their recapitalization in the supplementary budget law for 2001. We are also encouraged by the negotiations under way for a possible opening of one or two of the state banks to foreign partners. We hope that further progress in the reform of this sector will be forthcoming, particularly in the restructuring of state bank balance sheets and in clarifying the relations between banks and public enterprises. With regard to the latter, we support the staff's recommendation that financial support to loss-making enterprises be granted through explicit budget transfers rather than through bank credits, as is currently the case.

Welcome progress is also being made in tariff and tax reform. We note that the first phase of the tariff reform has been put in place with the 2001 budget and the second phase is to be implemented in 2002 which, according to the most recent announcement, will bring the maximum tariff to 30 percent instead of 40 percent as originally planned. This is an important acceleration in the tariff reduction schedule, particularly in the absence of an international mechanism that would give credit to Algeria's unilateral trade liberalization measures in multilateral trade negotiations, such as those ongoing with the EU and the WTO. This concern applies to a number of other developing countries. Still on tariff reform, it is important that the authorities address the weaknesses noted by the staff in the reformed tariff structure to ensure its effectiveness in encouraging private sector investment. With regard to tax reform, we welcome the steps taken to accelerate tax reform in the 2001 budget, and note in particular the reform of the VAT through the reduction in the number of rates, the extension of its coverage to retail trade, and the simplification of its procedures. This is a noteworthy achievement that should contribute effectively to the diversification of budget revenues. We also commend the authorities' continuing efforts to modernize tax and customs administration as well as budgetary procedures.

Still on structural issues, we note that questions surrounding land ownership continues to constitute a major constraint on economic development, particularly in the housing sector. We would urge that high priority be accorded to this issue which is crucial not only for housing construction, but also for industrial investment and agriculture.

In conclusion, once again we commend the Algerian authorities for their prudent macroeconomic policies since 1994, particularly in the face of large fluctuations in international oil prices. We also commend the important progress achieved in implementing market-oriented reforms and encourage the authorities to continue to press ahead, despite the difficulties, in order to increase employment opportunities and to improve living standards. We wish them every success in the period ahead.

Mr. Rustomjee submitted the following statement:

We commend the Algerian authorities for the encouraging economic progress that has been made, particularly since 1994. The results in macroeconomic stabilization have been remarkable with inflation rapidly reduced from around 40 percent in 1993 to a mere 0.3 percent in 2000. Substantial fiscal consolidation was achieved as reflected in a significant shift in the overall fiscal balance from a deficit of about 9 percent of GDP in 1993 to close to 10 percent in 2000. Even during the difficult years of 1998 and 1999, when oil prices were falling, the authorities managed to substantially contain the deficit. Important measures such as the realignment of relative prices and the liberalization of the trade and payments system, which should provide market incentives to the various sectors of the economy, were also implemented. Good progress has also been made in transforming the financial system and thereby achieving an important shift to direct instruments of monetary management and the liberalization of interest rates, measures which should help to improve resource mobilization and allocation. In the area of exchange rate policy, the exchange rate has been managed flexibly, and the continued application of such a policy appears to be beneficial in protecting the country from the destabilizing effects of oil price volatility by enhancing the response to such shocks. Owing to such exchange rate policy and a careful domestic demand management, the Algerian economy was able to weather the oil price shocks of 1998 and 1999. Moreover, progress was achieved toward deepening other structural reforms, including in the area of restructuring public enterprises.

Despite these promising results, the country still faces many serious problems, including a substantial reliance on the hydrocarbon sector, a high rate of unemployment and a large debt service burden, all of which will have to be addressed in the context of a medium-term policy framework. In this regard, the economic recovery program for 2001-04 that was recently announced is an important step in the right direction and we encourage the authorities to resolutely implement it. Following these general observations, we would like to concentrate briefly on a few areas of major concern.

The rate of unemployment in Algeria is very high and would need to be addressed effectively through prolonged and sustained efforts at economic reform, which place appropriate emphasis on the need to make economic activity more labor intensive. The capital intensity of production at present is relatively high as the hydrocarbon sector, despite its pivotal role in the economy in terms of foreign exchange and budgetary revenue, contributes little to job creation because of the low labor intensity of the production process. Therefore, the solution to the unemployment problem appears to depend much on the growth of the non-hydrocarbon sector, for which the efficiency of investment will need to be improved, as well as any profitable industrial activities downstream from the hydrocarbon sector that are labor-inducing.

In recent years, owing to the tight domestic demand policies and a recovery in oil prices, Algeria's balance of payments position has substantially improved. The external sector position, however, remains fragile because of the volatility of international oil prices and the negative impact of other factors beyond Algeria's control. To reduce such vulnerability, we encourage the authorities to diversify into other exports for which the opportunity exists. The success in export diversification will also have important implications for the progress to be made toward further reducing the heavy debt overhang.

The successful negotiation of an association agreement with the EU and possible membership with the WTO will require further tariff reductions, which could lead to a decline in trade taxes. In view of that, and to reduce the heavy dependence on international trade taxes and hydrocarbon revenues, there appears to be a need for increasing reliance on domestic taxes. In this regard, we welcome the authorities' intention to accelerate tax reform and, in the process, to reduce exemptions and tax evasion. Without high sustainable revenues, it will not be easy to revamp economic growth, which has been sluggish during much of the adjustment period. From the standpoint of enhancing growth prospects, we welcome the authorities' intention to relax fiscal policy in 2001. We also welcome the establishment of a stabilization fund in 2000, which can be used to finance the deficit and lower the stock of outstanding debt. The existence of such a fund will allow a significant portion of tax resources to be diverted to growth-promoting expenditures by reducing the reliance on such revenues to retire debt.

Continued progress with structural reforms will be critical to improve economic efficiency and enhance growth. In this regard, increased efforts will be required to promote the role of the private sector. Modernization of the banking system will be necessary to support a growing private sector and deepen financial intermediation.

With these remarks, we wish the Algerian authorities continued success in meeting the difficult challenges ahead.

Mr. Al-Turki made the following statement:

The Algerian authorities are to be commended for their sustained adjustment and reform under difficult domestic circumstances. It is heartening to see that these efforts have paid off in improved economic performance and increased resiliency to shocks. Indeed, while growth weakened last year due to drought conditions, inflation declined and both the fiscal and external positions strengthened.

The main challenge at this stage is to achieve sustainable high growth in order to address the unemployment problem. In this connection, I will make a few comments.

On the fiscal side, the authorities are to be commended for their prudent policies last year. The focus of the increased spending on infrastructural projects to eliminate bottlenecks and set the stage for higher growth is welcome. I also endorse the expansionary fiscal policy this year. Government finances are in a strong position and the need to reduce unemployment is large. Indeed, even with the increase in spending, the surplus is projected to remain substantial. In this connection, I welcome the authorities' plan to restrict the use of the surplus for debt amortization payments. The recovery plan should also boost growth prospects and help create jobs. However, the authorities need to be cautious in implementing the plan in future years and take full account of fiscal developments. Here, I agree with the staff on the importance of ensuring that the new infrastructural projects are economically viable.

On monetary policy, I commend the authorities for the success in containing inflation. I am also reassured by their objective to maintain low inflation and to preserve a comfortable level of foreign reserves. In this regard, ensuring adequate bank credit to the private sector is vital. Here, I welcome the authorities' cognizance of the importance of banking reform. While I welcome the progress made so far, I support the staff's call for strengthening efforts in this area.

Turning to the external sector, the increase in reserves should cushion the economy's vulnerability to external shocks. The exchange rate policy, under a regime of managed float, goes well with the objective of external adjustment. Moreover, the ongoing efforts to increase trade liberalization will enhance efficiency and competitiveness. In this connection, I welcome the recent ordinance on tariff reform.

In addition to prudent macroeconomic policies, improving growth prospects depends largely on structural reform and reduced domestic tensions. In this connection, I welcome the acceleration of reforms since October 2000. Indeed, during a ten-month period, a number of new laws, including those on liberalizing the telecommunications and mining sectors, have been adopted and a draft law on liberalizing the electricity sector was sent to parliament. Moreover, as noted in the staff report, the government sold its assets in the steel-making sector and a second mobile phone license was issued to a foreign investor. The Central Banking law was also amended and major work on various other reforms has taken place as detailed in paragraph 24 of the staff report. These are major undertakings that require effort and time. Drafting and adopting important laws cannot and should not be done in a week or a month. Therefore, I am surprised by the staff's multiple references to the slow pace of structural reform. We should realize that what matters at the end is the success of the reform effort rather than its speed.

As for the restructuring and privatization of public enterprises, I welcome the authorities' determination to move ahead on this issue. It is important to strike a balance, however, between the speed of privatization and the need for social support, especially in an economy with high unemployment. The pace of privatization is also influenced by the availability of interested and qualified investors. That said, the authorities are encouraged to do their utmost to advance the restructuring and privatization drive with the above noted constraints.

With these remarks, I wish the authorities every success.

Mr. Komatsuzaki made the following statement:

Since we acknowledge the authorities' efforts and agree with the thrust of the staff appraisal, we will focus our comments on a few areas of interest.

Fiscal Policy

We welcome the strengthening of the fiscal position in 2000. Related to this, we also welcome the establishment of a stabilization fund in 2000 to preserve the windfall gain from high oil prices. We encourage the authorities to maintain this prudent stance on fiscal policy. In this regard, we have some concern about the recovery plan. We understand the need to strengthen the infrastructure and to build a foundation for economic growth. Therefore, we support the plan for its purpose. However, the amount of planned expenditure is sizeable, and it is unclear whether there are enough investment opportunities to warrant this spending. Algeria, like many other oil-producing countries, faces a challenge in diversifying its industry structure. To achieve this, expenditures must be allocated effectively, and at the same time, structural reform should be vigorously implemented, a topic we will turn to later. We encourage the authorities to be cautious in implementing their plan, and to even consider extending its term. We welcome their intention to be flexible in reviewing the plan in line with Algeria's financial situation.

Structural Reform

Growth prospects for Algeria lie in whether it can make the transition to a market-oriented economy and achieve private sector led growth. A negative TFP growth during 1965–2000 in Algeria, as stated in Box 2, suggests enormous inefficiency in the past, and that many issues still remain. Structural reform is key to gaining economic efficiency and ensuring long-term economic growth. In this regard, we are concerned about the stagnation of structural reform over the past few years. The recovery plan, as the authorities rightly say, should be supplemental to structural reform, not the other way around. More specifically, we must stress the importance of promoting competition in a broader part of the economy. In this regard, we urge the authorities to speed up privatization, customs and tariff reform, and reduction of administered prices.

Data Issues

A serious data problem, inter alia, in monetary and banking data and fiscal data, is a threat to the conduct of macroeconomic policy. We would like to see the authorities' effort in this area and urge them to take advantage of technical assistance offered by the IMF, the World Bank, and other available resources. We also encourage the authorities to participate in GDDS.

Mr. Jang made the following statement:

I would like to join the previous speakers in thanking the staff's effort for their well-written paper and Mr. Daïri for his helpful statement. We commend Algeria for making considerable progress, in spite of a difficult situation in restoring macroeconomic stability and achieving comprehensive structural reforms following the Fund–supported program in 1994. Nonetheless, the large size of the hydrocarbon sector in the economy still makes Algeria vulnerable to changes in oil prices, as witnessed in the ups and downs of the country's economic performance in recent years. This will only highlight the necessity of further prudence in macroeconomic policies and structural reforms for supply-side–led economic growth. Since we agree with the broad thrust of the staff paper, we shall raise only a few points for emphasis.

While the authorities should be commended for conducting a more expansionary fiscal policy to boost growth prospects and reduce unemployment, we share the staff's view that the recovery plan should be implemented prudently over the medium term, since the recovery plan substantially increases the budget's vulnerability in case of a downturn in oil prices. Furthermore, an ongoing surge in capital expenditures would raise inflation, considering that the plan is relatively front-loaded, and raise the risk of initiating investment projects whose economic justification is not firmly grounded. Thus, a more careful analysis on the timing of launching new projects would be desirable, and we recommend that the authorities consult with international financial institutions to review the quality of related expenditures.

We also welcome the authorities' commitment to quick and broad-ranging privatization of public enterprises. However, we are concerned that the privatization program is somewhat delayed, since it would be a core element of the other structural reforms. We share the staff's view that the authorities should use a transparent, efficient, and nondiscriminatory framework of privatization, and continue consulting with all concerned parties, including workers.

Considering the financial condition of the state–owned banks, we suggest that the authorities should complete the restructuring of bank balance sheets and undertake budget transfers in financial support of loss-making public enterprises. While we welcome the authorities' plan to introduce a comprehensive tariff reform, it should not increase the possibility of protection, since protection would undermine the competitiveness of a large number of sectors. We also commend the authorities' effort aimed at achieving a more efficient tax system.

We also join the other Directors in encouraging the authorities to promptly implement other structural reforms, such as housing, judicial reforms, and the liberalization of the remaining administered prices. I would like to stress the importance of producing timely economic data so that the authorities could better monitor the economic conditions and formulate economic policies correctly. In this respect, we encourage the authorities to strengthen data coverage, quality, and timeliness.

With these remarks, we wish the authorities every success for the future.

Mr. Bauche made the following statement:

In many respects, the Algerian economy has achieved commendable progress since 1994 and the outlook remains relatively positive. Now the tree must not hide the forest, and the Algerian economy is still hampered with daunting difficulties, the most significant being growth rates well below potential, combined with extremely high unemployment, and insufficient diversification of exports. The economy continues to face major challenges over the medium term. We agree with the staff that such challenges call for comprehensive structural reform. As recalled by the staff, and I quote, "effective progress on the structural front has been excessively slow in 2000."

Some encouraging progress has been achieved in 2001, and the intensification of efforts to reinvigorate reforms, as recently demonstrated by the adoption of three ordinances—including the introduction of a new investment code—bode well for the future, as recalled by Mr. Daïri in his preliminary statement. We believe that the overriding objective of structural reforms should be to strengthen the growth potential in the non-hydrocarbon sector in order to limit the strong dependence of the overall financial situation on fluctuations in oil and gas prices.

The other equally crucial objective should be to reduce the unsustainable unemployment rate, which contributes to a difficult social climate. With this acknowledged social sector situation, I therefore believe that the priorities identified by the staff are broadly appropriate, and I will make three comments for emphasis. First, we agree that the restructuring and, in many cases, privatization of public enterprises should be a central element of the reform beyond the useful steps already taken in liberalizing the telecommunications and mining sectors. The provisions of the new law present a welcome step. The much-needed improved investment climate calls for further measures aimed at attracting private capital, including through the promotion of a rules–based competitive environment. Bearing in mind that ultimately further consolidation of the domestic sector situation also represents a crucial condition for attracting new investments. Also, as indicated in the report, the restructuring of the public sector will have adverse consequences on the labor force, and we very much agree with the staff's recommendations that the social safety net should be extended to reduce the social costs of the transition.

Second, we also concur with the staff in their assessment of the banking sector, which still suffers from major weaknesses, and I associate myself with the comments previously made.

Concerning fiscal discipline, we share the staff's views that, while the recovery plan and the easing of the fiscal stance are appropriate in a difficult context, the acceleration of structural reforms remains an essential prerequisite for a permanent rise in the country's growth trend. On the stabilization fund designed to save extra hydrocarbon revenues, we agree with the staff on the transparent functioning of this recently created tool.

To conclude, let me congratulate the staff for their remarkable work. We have today before us a precise and well–documented description of the Algerian economy with useful recommendations that are an excellent base for a strengthened relationship between Algeria and the Fund.

Mr. Kpetigo made the following statement:

Over the past three years, the Algerian authorities have made significant progress in the implementation of economic and financial policy measures, and have adapted rapidly to the changing economic situation. Indeed, the authorities made policy changes during 1998–99 when oil prices fell and the low fiscal revenue prevented them from implementing ambitious programs. The resulting reduction in the fiscal deficit and the stabilization of foreign exchange reserves had possibly been due to the appropriateness of macroeconomic management in the context of falling oil prices. Subsequently, as the fiscal situation improved, the authorities eased the fiscal stance. Furthermore, as oil prices increased over the second half of 2000 and in 2001, the authorities established the stabilization fund through the budget law built on conservative oil price assumption in order to preserve these resources. We commend the authorities for their prudent approach.

Despite these commendable efforts and achievements, economic growth remained substantially below potential. Also, unemployment remains high, while economic diversification is still weak. In addition, the pace of structural reforms has been slow. Therefore, the authorities have adopted a recovery plan aimed at boosting economic growth. However, as the staff points out, to have a lasting effect on output and employment, the recovery program has to be a supplement to, not a substitute for, structural reforms.

Regarding the unemployment problem, we share the views expressed by Mr. Rustomjee that the solution depends mainly on non–oil sector growth. On the program itself, we welcome the fact that, despite the stimulus that it will have, inflation is likely to remain low in 2001. However, this may not be the case in the outer years, as demand-led pressures are likely. We therefore urge the authorities to follow a prudent monetary policy stance so as to minimize price increases.

On privatization, we agree with the staff that there is room for an acceleration of the privatization program, especially for smaller units. We are also of the view that the process should be kept transparent, that the government should rely on competitive bidding, and that the social and human costs of the transition should be given full consideration. Can the staff indicate if there is any plan to extend the social safety net?

On banking system reform, while we noted that the share of private banks is rapidly increasing, we note also that the share of the six state–owned banks in total bank assets still exceeds 90 percent. Given their weak balance sheets, this constitutes a threat to the stability of the financial system, and these banks do not play their role as the efficient intermediary. They may also be slowing the efforts of the authorities to develop a stronger private sector. We therefore join Mr. Al-Turki and Mr. Komatsuzaki in urging the authorities to accelerate the process of privatization of the financial system.

On exchange rate policy, we share the staff's recommendation to enhance the role of market forces in the determination of the exchange rate, the complete elimination of surrender requirements of non–oil exports, and the possibility of progressing with reducing the surrender requirements of oil export receipts to the central bank. We encourage the authorities to eliminate or reduce exemptions and tax evasion, and to accelerate tax reform, notably the reduction of the VAT rates, the extension of the VAT coverage to retail trade, and the simplification of its procedures. Their recovery plan calls for the elimination of the weaknesses of data provision and for an appropriate monitoring of economic achievement, if the goals pursued by the authorities are to be achieved. To this end, we urge the authorities to fulfill the staff's recommendation as regards the strengthening of data coverage, quality, and dissemination, including the GDDS.

With these remarks we wish the authorities every success.

Mr. Wong made the following statement:

We thank the staff for an informative and well-balanced report. We would also like to thank Mr. Daïri for his very helpful and comprehensive preliminary statement. Algeria has indeed made very impressive progress in stabilizing the macro-economy under Fund-supported programs in the past eight years. We join the staff and other Directors in commending the authorities for their skillful macroeconomic management.

Internally, during the period, monetary growth has been well contained, allowing inflation to come down from very high double-digit figures to virtually zero last year. At the same time, efforts in fiscal consolidation have turned the color of the fiscal balance figure from red into black. The policy mix has, on balance, facilitated a considerable decline in interest rates. On the external front, the current account performance has, by and large, remained subject to what happens to oil prices on the world market. However, the economy weathered the global downturn in oil prices very well in 1998 through 1999, thanks to the earlier adjustment efforts, which had increased the economy's resilience to shocks. This was reflected in the current account performance in those years. Since oil prices reversed course in 2000, the economy has been in a good position to capture the benefits of the upturn. The current account turned in a huge surplus. Government finance has strengthened substantially. Foreign reserves rose sharply and more foreign debt was paid down, reducing the country's external vulnerability. We welcome the establishment of an oil stabilization fund for easier demand management in the long term.

Looking forward, it seems we have now come to a stage where we should start worrying about inflationary pressures again, especially with the staff statement now reporting a 6.3 percent inflation rate for the year ending July. Staff comments are welcome, particularly in regard to how much is attributable to monetary growth following the considerable increase in net foreign assets. In this connection, we also share the staff's concern over the more expansionary stance of fiscal policy, but we welcome the authorities' readiness to tighten policy if unforeseen adverse circumstances materialize. The authorities may wish to consider the staff's recommendation of a more active use of indirect monetary policy instruments to fine-tune monetary conditions.

Despite the enviable stabilization achievements, Algeria has grown slowly, with persistently high levels of unemployment and poverty. We commend the authorities for drawing the recovery plan for 2001–04 to tackle the issues, seizing the opportunity of the current upturn to improve the country's infrastructure and to raise living conditions in the poor areas. However, we also concur with the staff that, in order to address these long-term issues successfully, it is important that the authorities bring the economy on a sustainable long-tem growth path. And the most effective way of doing this is to complete the transition toward a much more market-oriented economy by accelerating the pace of structural reforms. We thus join the staff in welcoming the authorities' assurances that the plan is no replacement of the effort in structural reforms. We also thank Mr. Daïri for the detailed illustration of the authorities' recent efforts (in the utilities, trade, and banking sectors) and firm commitment.

Finally, on the issue of statistics, while we agree that more resources need to be allocated for the compilation of statistics, we suspect that expertise may be more of an issue than resources. We thus support that technical assistance be provided to Algeria in this regard.

With these remarks, we wish the authorities continued success in meeting their future challenges.

Mr. Ralyea made the following statement:

The staff assesses the authorities' macroeconomic policies as broadly positive. We are inclined to agree and believe high oil prices and a strong balance of payments position offer a golden opportunity to accelerate structural reforms. In that regard, we welcome the recent signing of three ordinances to improve the trade and investment regimes. At the same time, Algeria's economic and fiscal dependence on oil receipts leaves it highly vulnerable to swings in oil prices. Thus, the staff's recommendations to accelerate the pace of trade and tariff reform and privatization, as well as strengthen the financial system, seem appropriate and realistic.

Large oil-related inflows also present the Algerian authorities with a decision on how best to use the associated increase in international reserves to meet Algeria's pressing developmental needs. The staff has suggested that the authorities manage their external liabilities more actively and identified one potential use of reserves in that context—advance repayment of obligations to the Fund. We urge the authorities to consider this option seriously. Advance repayment would send a positive signal to potential investors of Algeria's economic strength. It would also be consistent with the temporary use of the general resources of the Fund, as provided in the Articles of Agreement.

Fiscal Policy

The staff correctly identifies several shortcomings of the authorities' counter-cyclical fiscal policy. To the staff's list, we would add the risk that investors will view counter-cyclical measures as a lack of commitment to prudent fiscal policies, notwithstanding the authorities' pledge to limit spending to developments in the international oil markets. We urge the authorities to be extremely cautious in the presentation and implementation of any counter-cyclical measures and agree with the staff and the French chair on the need to complement fiscal stimulus with structural reforms.

We also welcome the establishment of a Stabilization Fund, which should help moderate the effects of oil price volatility on the budget. However, Algeria's over-dependence on oil-related fiscal revenue remains. In that regard, when does the staff think the benefits from the several IMF technical assistance missions in the area of tax administration will materialize in the form of higher tax revenue relative to non-oil GDP?

Monetary Policy

We welcome the authorities' plan to devote monetary policy to the maintenance of low inflation, though we note that continued capital inflows, the anticipated draw down of government bank deposits to fund the economic recovery plan, and the desire to maintain external competitiveness through a managed exchange rate complicate the execution of monetary policy. To sharpen the focus of monetary policy, we second the staff's and other Directors' calls for the authorities to continue moving toward a more flexible exchange rate regime, including the removal of surrender requirements for exporters.

At the same time, we are dismayed to learn that the authorities have taken steps that appear to reduce the independence of the central bank. We agree with the staff that these moves represent a step backwards and are contrary to the authorities' objective of improving monetary policy management.

Structural Reforms

The authorities' economic reform agenda provides a good roadmap for Algeria's efforts to encourage private sector-led, sustainable growth. In this regard, we encourage the authorities to implement quickly the National Council for Banking Reform's plans. We also encourage the authorities to make reform of both land ownership laws and construction finance institutions a priority given the scope of Algeria's severe urban housing shortage.

Data Collection and Reporting

Finally, we welcome the authorities' decision to publish the Article IV document, but, like several other Directors, remain concerned about the deterioration in economic data. We urge the authorities to devote adequate attention and resources to reversing this trend.

The staff representative from the Middle Eastern Department (Mr. Lazare) made the following statement:

There were two comments in the preliminary statements, one by Mr. Kelkar and the other by Mr. Padoan. Mr. Kelkar requested more details on the policy regarding state–owned enterprises and privatization. Public sector reform—in particular reform of state–owned enterprises in the non–financial sector—is key to the completion of the transition toward a market–oriented economy in Algeria. While a number of state–owned enterprises are profitable and competitive, others—in particular a small number (less than a dozen) of large industrial companies—generate large losses and constitute a heavy burden for the public banks and ultimately for the Treasury.

To tackle this issue, the government's policy, as we see it, has three aspects. First, the government is determined to subject these enterprises to the right incentives. In the staff's view, the tariff reform and the conclusion of the negotiation on the accession agreement with the European Union are key elements in that respect. These elements will be powerful incentives for the enterprises to raise their productivity and to increase competition.

Second, the government wants to increase accountability at the enterprise level by eliminating, as mentioned in the staff statement, the so-called public holdings. Third, the government wants to privatize or conclude partnership agreements whenever possible. The transfer of all the public assets in the steel-making sector to a private company majority–owned by a foreign investor is a good example of what this policy could bring. Such privatization and partnerships are expected to improve profitability and competitiveness.

In addition, the staff suggested that, because time is required to allow these public enterprises to adjust to competition, direct budget subsidies would provide a necessary cushion. These subsidies would also allow for better transparency in the costs of the public sector and, more importantly, they provide the proper environment for banking sector reform.

The second question was on inflation. As noted in the staff report, Algeria had a good inflation performance in 2000, with a 0.3 percent average increase in the CPI. However, this performance was due partly to exceptional factors, such as the decrease in prices of fresh food products. In the staff medium–term scenario, inflation is expected to pick up from 2001 to higher than 6 percent in 2002/03 and to recede subsequently. The initial rise is already under way. It is due in particular to the recent turnaround in food prices and to the large increase in wages in early 2001. Inflation will be fueled later this year and in the next two years by the implementation of the recovery plan, which will boost aggregate demand.

While there is a significant increase in money supply in 2001–03 in the scenario, due essentially to surging net foreign assets, the demand for money of the hydrocarbon sector is also expected to increase significantly in a context of favorable hydrocarbon prices. Specifically, it is expected that the state–owned oil company's deposits in the banking system will increase significantly. This, rather than factors linked to changes in financial intermediation mechanisms, explains the increase in the liquidity ratio noted by Mr. Padoan. The return to lower inflation rates after 2003 would be fostered by the progressive phasing-out of the recovery plan and a relatively prudent monetary policy.

There were also a couple of questions raised today. Mr. Kpetigo asked if there was any plan to extend the social safety net. I think the government welcomed the proposal by the staff to strengthen the social safety net and to use it in case of labor retrenchment as a result of privatization. However, I am not aware of any particular plan to extend the social safety net at this stage. It remains more of a plan than a real decision at this point.

On tax administration, the question was asked if the staff expects some new revenues due to changes in tax administration. We had hoped that revenues would increase due to improvement in tax administration. In particular, the Department for Fiscal Affairs aims at creating a large taxpayer unit, which would go a long way in improving tax collection vis-à-vis medium and large enterprises. I heard from Algiers this morning that several decisions have been taken in the last few days to implement this large taxpayer unit. So, this is in progress.

Let me finish by saying that this tax administration, as well as measures taken in terms of customs administration and the recent ordinances on tariff reform and on tax incentives are very much consistent with the recommendations made by the Fiscal Affairs Department during various missions.

Mr. Maciá made the following statement:

Algeria has successfully implemented policies to strengthen its macroeconomic stance. The authorities have taken cautious steps to liberalize the telecommunications and mining sectors, and are determined to proceed with a demanding reform program, despite existing security and cultural unrest. They have also kept inflation under control, made progress in liberalizing external trade restrictions, improved the balance of payments position, and curtailed debt. The authorities are also determined to conclude by year-end the World Trade Organization membership issue and the association agreement with the EU.

The agricultural sector was hard hit by climatic conditions, while other sectors reported slow growth, including the promising hydrocarbon sector. This overall situation hindered real growth in 2000 and the unemployment rate remained high.

The fiscal stance has been prudently managed in view of the fluctuations in international oil prices, with windfall revenues being set aside in a stabilization fund. The authorities have curtailed expenditures, kept up capital investments, and reduced debt and arrears. We are encouraged by the ongoing tax and customs reforms, the steps to expand the VAT coverage, and the decisive steps against tax evasion and exemptions.

On the monetary front, bank liquidity improved and lower refinancing rates allowed interbank rates to decline. However, credit has remained very limited. There has been a major improvement in the external position, with a significant current account surplus and growth of the financial system strengthening considerably. Progress has been noted in some structural areas, particularly the transfer of public assets in the steel-making sector and iron ore mine, the draft law liberalizing the electricity and hydrocarbon sectors, tariff reforms, and the compromise to privatize some government entities.

Increased efforts are needed to enhance private sector participation to deal with labor market issues, improve the judicial system, and provide for a more competitive financial sector. We welcome the recovery plan. There are measures in the supplementary budget to recapitalize public banks and strengthen bank supervision under the Fund's technical assistance. In addition, it is important to follow through the agenda for open privatization and concessions in construction activities, food processing, hotels, airport terminals, the oil refinery, and oil production sharing agreements, among others.

Challenges remain to improve the economic liberalization efforts that are under way and increase further Algeria's competitive advantage. Issues related to high employment costs for new businesses, layoff constraints, and the further reduction of payroll taxes need to be dealt with. Though we are encouraged by the liberalization efforts in some sectors, steps are necessary to open to the private sector the provision of public services, such as water services, ports, and other public infrastructure. Streamlining the existing tariff system that primarily protects special interest groups and inefficient public enterprises would enrich the environment, remove the anti–export bias in the system, and remove the deterrent as explained in Box 5. We would like to know where is the real potential for export diversification for Algeria, given the endowments and the competitive advantage. Table 34 of the statistical appendix lists six to eight areas in which Algeria is engaged in exports other than energy.

To conclude, we commend the authorities for the progress attained and encourage them to persevere with the demanding agenda that lies ahead.

Mr. Ábel made the following statement:

Most of Algeria's achievements—its impressive export growth, stronger foreign reserve position, and budget surplus—are probably temporary, because the incomplete nature of the authorities' policy changes cannot ensure the sustainability of the improvements.

However, it is a significant improvement that whenever oil revenues temporarily exceed the amounts foreseen in the budget, the excess is diverted into a stabilization fund. It is also encouraging to learn that the bulk of the excess was used this time to reduce Algeria's outstanding debt. But, the central bank's practice of mingling these funds with the Treasury account risks making it easier to use them to finance current deficits.

Inflation continued to decline during 2000 but picked up again in 2001, perhaps as a reflection of that year's monetary conditions and expansionary fiscal policy.

The uneven pace of structural reforms kept the recovery plan from producing the expected improvements in growth and materially increased the vulnerability of the budget.

The sluggish implementation of the privatization program and banking sector reforms—both crucial for a well-functioning market economy—may slow the progress of other structural reforms.

The staff's recommendations and the authorities' willingness to liberalize and deepen their money markets will reinforce the effect of market forces on the exchange rate and other prices, ultimately leading to a more efficient resource allocation. The speed and vigor of these changes depend crucially on making progress with structural reforms.

We hope for much improvement coming from internal reforms in coming years, when external conditions may be less favorable for Algeria.

Mr. Lissovolik made the following statement:

Algeria's economy is, at present, experiencing relatively favorable conditions for economic development, which is primarily determined by notable improvements in the country's terms of trade. Another important factor in the amelioration of Algeria's economic environment has been the reform effort by the authorities launched in 1994, and that is currently in need of a further impetus, most notably in the sphere of structural reforms. Recent developments are encouraging in this respect as exemplified by the adoption of laws aimed at trade and investment liberalization, and as is noted in Mr. Daïri's insightful preliminary statement, conducive to further integration of Algeria into the global economy. Further advances need to be made to address the problem of high unemployment and diversification of exports.

Since I am in broad agreement with the thrust of the staff appraisal, I will confine myself to just a few observations concerning unemployment monetary policy, trade reform, and the country's debt position.

At the outset, I would like to stress the importance of combating unemployment, which is nearly 30 percent of the labor force, and building a viable social safety net. Given the centrality of these issues for Algeria, I believe that they should merit greater attention in the staff report. One illustration of the problems in the social sphere that is identified in the report is the increasing strains, associated with demographic developments in the country's pension system. The need to actively pursue the social dimension in economic reforms is particularly important, given the adverse consequences of delays on the country's macroeconomic and political stability.

On trade reform, of the number of structural reforms targeted at present by the Algerian authorities, trade reform is justifiably accorded top priority. It appears that the implementation of trade reform is particularly in need of being expedited in order for the country to take advantage of the significant cushion of the high current account surplus. It also appears that, according to the staff's calculations, the impact of trade liberalization on fiscal revenues is likely to be positive. This outlook appears to be rather optimistic in light of the conclusions of the recent paper on the revenue implications of trade liberalization (SM/01/225), which acknowledges the possibility of significant revenue risks associated with trade liberalization in the short term. In this respect, what factors within Algeria's trade reform package favor the optimistic assumptions of the staff with regard to the fiscal effects of trade reform? Also, apart from the fiscal effects of trade reform, what effect could the recent plans for trade liberalization have on Algeria's current account balance?

Furthermore, as is argued in the staff paper on trade liberalization, "even allowing for the positive revenue effects in the initial stages of liberalization, continuing tariff reductions will ultimately lead to a decline in the relative importance of trade tax revenue, underscoring the need for early action to develop and strengthen the domestic tax base, as well as tax and customs administrations." Accordingly, the importance of further progress in tax reform, emphasized by the staff in their report, becomes all the more crucial and is just one reflection of the larger problem of the need for proper coordination of the implementation of various components of the structural reform package.

On price liberalization and monetary policy, we concur with the staff and Mr. Padoan that the floating exchange rate regime is well suited to insulate the country from external shocks. At the same time, the institutional framework of monetary policy may be substantially debilitated in case the independence of the central bank is seriously compromised. The latter problem becomes particularly acute, given the risks associated with looming inflationary pressures, which, in our view, as rightly pointed out by Mr. Padoan, are potentially worrisome. A lot will depend on the ability of the Algerian authorities to limit the growth of the M2 money supply aggregate, which, according to the findings of the staff (Occasional Paper 165, *Algeria: Stabilization and Transition to the Market*), is the most important determinant of inflationary dynamics, along with changes in the nominal exchange rate and movements of the oil price. We agree with the staff that price controls should be eliminated, with a transparent system of targeted transfers providing the necessary social protection for the vulnerable strata of the population.

On debt position, the Russian authorities confirm that some advancement has recently been made toward resolving the issue of Algeria's debt to Russia. This said, the Algerian authorities' announcement reflected in the staff paper that "a mutually acceptable settlement of the debt to Russia was within reach" is an exaggeration. We, therefore, look forward to achieving substantial progress during the forthcoming bilateral meeting in September and urge the Algerian authorities to take a constructive position at these negotiations.

With these remarks, we wish Algeria's authorities every success in making further advances toward their economic policy goals.

Ms. Alcaide made the following statement:

The Algerian economy should be commended for the strong record of policy implementation, particularly since 1994, which has strengthened the country's resilience to external shocks and resulted in macroeconomic stabilization, inflation reduction, substantial liberalization and reform and external viability.

Despite the many advances made in liberalization and the commitment shown by the authorities to implement sound economic policies, the country has yet to create the conditions to achieve a higher growth path allowing to reabsorb unemployment and accomplishing the structural transformation from a planned economy to a market-oriented one.

The improvement in the fiscal and external positions registered in last year has permitted the easing of the fiscal stance for 2001, with the objective of providing a growth impulse to the economy. In the same direction to revitalize economic growth, the authorities announced the recovery plan for 2001–04. While I endorse the easing of the fiscal stance in the current circumstances, I concur with the staff that a permanent growth trend would require an acceleration of the implementation of structural reforms.

I also welcome the authorities' intention to implement the recovery plan in a flexible manner with due consideration to the financial situation in the coming years. It is encouraging to hear from the authorities that the recovery plan will not be a substitute for the needed structural reforms.

In this regard, notwithstanding that the structural reforms already implemented are commendable, much remains to be done to improve economic efficiency and enhance growth.

As the staff points out, increased efforts are needed to intensify competition with the essential components of trade and tariff reforms and strengthen the financial system.

Like other chairs, I endorse the managed flotation of the dinar so as to avoid real effective appreciations and safeguard competitiveness.

In sum, the challenges are still great. However, the commitment shown by the Algerian authorities gives us hopeful prospects for the future.

With these remarks, I wish the Algerian authorities continued success.

Mr. Yakusha made the following statement:

Since 1994, the authorities have achieved commendable progress toward the restoration of macroeconomic stability and the implementation of a comprehensive set of structural reforms. Recently, the macroeconomic performance was affected more by the favorable situation in the hydrocarbon sector than by the accumulated effects of structural reforms. What is really impressive is that the authorities seem to be aware of the window of opportunities created by high energy prices, and are poised to use it by accelerating structural reforms.

The reversed situation in 2000 and the first half of 2001, coupled with cautious financial policies, led to a dramatic improvement in the fiscal and external positions. The reserve position of the country is particularly impressive.

I agree with the general thrust of the staff statement that the medium-term prospects for the Algerian economy seem to be bright enough, provided structural reforms are consistently being implemented. If this is not the case, the unemployment problem is unlikely to be comprehensively addressed, which is going to create an additional challenge in the existing complicated social and security environment. With respect to the staff appraisal, I am somewhat puzzled by the staff's statement emphasizing that the recent measures enacted by the authorities do not require changes in the appraisal presented in the staff report. I would have thought that more credit may be given to the authorities for at least further trade liberalization and other measures aimed at opening and privatizing the economy, and that the relevant too cautious staff assessment could, and should, be improved in the summing up of today's discussion.

The policy response of the Algerian authorities, the so-called economic recovery plan, deserves support. The authorities are right by trying to increase private sector participation in the economy through cautiously stimulating the economy while keeping an eye on inflationary pressures and possible changes in oil/gas prices. I think that the front-loading of the fiscal incentives is appropriate, given the uncertainties with future global developments and the global demand for energy. I have a concern though, stemming from the trend of investment seemingly heavily centered around government investments, which could be less efficient than private ones. Moreover, the statistical appendix suggests that the overall gross investment in the country even declined somewhat as a share of GDP in 2000, while gross capital formation has been more or less stable notwithstanding successes in the hydrocarbon sector. I wonder whether the staff has any information about investment data so far in 2001 and whether the crowding out of private investors by the government could become a subject for concern.

Mr. Kelmanson made the following statement:

I am grateful to the staff for the papers before us today, and overall can agree with the staff assessment. In particular, we welcome the prudent macro policy stance of the authorities. We agree that the managed float has been appropriate in safeguarding competitiveness, while dampening the impact of external shocks, and agree that very significant medium–term challenges remain. We strongly welcome the commitment to transparency as well, as evidenced by the publication of the 2000 Article IV staff report, and further progress here along the lines proposed, including judicial reform, will be most important. But, while the authorities should be rightly proud of their record on macro stabilization, as most have already noted, serious challenges remain in generating lasting growth and falling unemployment. In particular, we would stress the need for continued structural reforms to enhance the environment for private sector activity, and we are glad that the authorities agree on this and look forward to even more rapid progress in this area than was seen in 2000.

Echoing a point made by others, I would note that the current external environment—in particular the current high oil prices—presents an ideal opportunity to make structural changes that can sometimes be tough in a context which is somewhat benign, and this is an opportunity that should be taken and not missed. Notwithstanding that, the process of structural reform may be painful, and therefore the staff's suggestion of an enhanced social safety net is appropriate, and we would be interested to hear from the staff some further detail on what work has been done, or is planned, on assessing the possible social impact of reforms and how they might be mitigated.

The staff representative from the Middle Eastern Department (Mr. Lazare) made the following statement:

First of all, Mr. Maciá asked what was the real potential for the diversification of exports. While it is always difficult to pick the future winner, my guess is that Algeria has some potential in terms of agricultural products, energy–intensive products, and possibly in such services as tourism, which starts from a very low base. We have at the moment some anecdotes of relatively small private sector enterprises that have started looking at alternative exports, which is a positive sign. However, at this initial stage of diversification, it is too early to identify which export products have the real potential.

There was a question raised on the effect of trade reform. I think the important thing to keep in mind is that, in the case of Algeria, tariff reform involves both the lowering of the tariff rates and reclassification of goods along the various rates. Thus, based on this two-track approach, it is expected that the new rates passed by the recent ordinance—5, 15, and 30 percent—may result in additional revenues, not a loss in revenue. This would be due entirely to the fact that some relatively processed goods that are currently classified at low tariff rates would be reclassified at higher rates. Also, the new tariff rates would be more consistent with the usual recommendation that goods should be classified in accordance with their degree of processing.

On the current account, I would expect an increase in imports in the short term, but that would be offset in the medium term if the anti-export bias of the existing tariff is reduced, and the diversification of exports effectively takes place.

On the possible crowding out of private sector investment by public investment, the government's economic plan is very much geared toward infrastructure rather than toward enterprises for capital development. Thus, the risk of crowding out private enterprises is relatively limited. What we see in practice is more of a crowding out of public enterprises by the private sector, in the sense that public enterprises have little funds available to invest, while the private sector is investing in a number of sectors, particularly in food-processing and textile industries, where substantial market shares have been accounted for by the private sector. Moreover, the production of public enterprises has declined against a sharp increase in the private sector.

Finally, on the social impact of reforms, I am not aware of any particular study that has been done by the Algerian authorities or by other international organizations that would specifically quantify the possible impact of reforms. It is possible that the restructuring and privatization of public enterprises would create some labor retrenchment, but it is probably not the case in all sectors. Some privatization projects, such as cement plants and hotels, would probably not generate a lot of labor shedding. It is also true that a fair amount of labor shedding occurred already in 1996, 1997, and 1998. Therefore, part of the excessive labor force in public sector enterprises has already been cut, and that should also alleviate the problem. However, the staff remains of the view that a strengthening of the social safety net is useful and would provide a cushion necessary for implementing these reforms.

Mr. Daïri made the following concluding remarks:

First of all, I would like to thank the staff for the comprehensive responses and clarifications. I would only comment briefly on a few points. First, of course, we have to recognize the domestic situation and the importance that the authorities attach to ensuring social cohesion and social stability, as well as to reducing regional disparities—an overriding objective that goes hand in hand with the objectives of enhancing the growth momentum and reducing unemployment. Of course, when there is a need to strengthen the social safety net in parallel with progress in public enterprise reform, the authorities would give it highest consideration.

I would also like to mention briefly the issue of investment efficiency and total factor productivity (TFP), to which Mr. Padoan and Mr. Rustomjee have referred. As indicated in Box 2 of the staff report, after a continuous decline in TFP, that decline has been reversed by the structural reform in the 1990s, and stronger improvement is expected with the increased momentum of structural reform. Trade liberalization will also increase efficiency and would probably have positive implications for TFP, as some of the distortionary customs valuation practices have been replaced by temporary duties, which will be reduced progressively. Therefore, with improved efficiency through trade liberalization, there is a potential for improvement in the overall availability of goods under the process as well.

On the recovery program, I would like to mention that there is no white elephant. Most of the government's projects are oriented toward local development and toward reducing infrastructure bottlenecks, which will increase the availability of means to develop production, particularly for small farmers and the rural population.

On privatization, there has been a significant change from what was described in the staff report, because the list of enterprises to be privatized has been eliminated, and now all sectors of the economy have been opened up to the private sector.

On the land issue mentioned to by Mr. Shaalan, I would like to refer to the proposal for leasing agricultural land on a long–term basis, and also to the fact that the new investment agency, which has just been created as announced in the new law, will make available to investors public land that is presently unavailable.

As regards the exchange rate system, the exchange rate itself moves, of course, freely, when possible, and progress will continue to be made in deepening the foreign exchange market.

With regard to the points raised by Mr. Ralyea, Mr. Lazare has already responded on the issue of technical assistance. Mr. Ralyea also suggested that Algeria make early repurchases. While the authorities do not consider this possibility at the moment, they keep it under review, and if and when possible, they will do so.

Finally, I would like to thank all Executive Directors for their interest and support. I will convey their recommendations and suggestions to my Algerian authorities.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities' prudent macroeconomic management and progress in restoring macroeconomic balances under difficult circumstances and in the context of rapidly changing oil prices. A prudent fiscal stance and cautious easing of monetary conditions have led to a major strengthening of the balance of payments position and a large accumulation of official reserves. External debt indicators have improved, and the inflation rate has declined sharply.

Nevertheless, Directors noted that the Algerian economy still faces major challenges over the medium term. Higher economic growth is needed to reduce unemployment and improve living standards, and the export and revenue bases need to be diversified to reduce external and fiscal vulnerability. In Directors' view, these require the introduction of a comprehensive set of reforms to promote private sector investment and raise the efficiency of new investment, particularly in the non-hydrocarbon sectors. In this context, Directors stressed the importance of privatization, restructuring of public enterprises, comprehensive banking reform, enhanced competition, and further trade liberalization.

In the face of mounting social demands, low growth and inflation, and strong fiscal and external positions, Directors endorsed the fiscal stimulus being introduced in 2001, and the authorities' 2001-2004 economic recovery plan. They considered that the recovery plan could temporarily boost growth and thereby reduce unemployment and poverty in the short term, and would not jeopardize Algeria's fiscal and external positions as long as oil prices do not drop significantly from their current levels. However, Directors encouraged the authorities to review the quality of expenditures in consultation with the World Bank. They stressed that the recovery plan would have to be complemented by the accelerated implementation of structural reforms to strengthen growth on a sustainable basis. Directors expressed concern about a possible resumption of inflationary pressures and the vulnerability of the public finances to a marked downturn in oil prices. In this regard, they were encouraged by the authorities' commitment to adjust fiscal policy to future developments in the oil market and to maintain a cautious monetary stance.

Directors welcomed the authorities' commitment to manage the exchange rate float in a flexible way to safeguard competitiveness and dampen external shocks. They recommended that the exchange system be further liberalized to strengthen the role of market forces and to continue reducing the importance of the parallel market, noting that liberalization is particularly appropriate in the current context of a strong reserve buildup.

While Directors expressed concern at the overall pace of structural reforms in 2000, they welcomed the reforms implemented in 2001 as well as the authorities' assurances that their recovery plan would not be a substitute for accelerated structural reform. Directors were encouraged by recent achievements, including the sale of a second cellular telephone license, the transfer to a foreign investor of public assets in the steel- making sector, and the recapitalization of state-owned banks. They welcomed the recent ordinance extending the scope of privatization to all economic sectors and streamlining its procedures. Directors emphasized that privatization should be undertaken in a transparent manner and in consultation with all concerned parties. They suggested that the social safety net be strengthened to cushion the impact of public sector restructuring in the event of labor retrenchment.

Directors were encouraged by the adoption of an ordinance simplifying the investment incentives structure and leveling the playing field between public and private investors as well as foreign and domestic investments. They also welcomed the government's efforts to implement a comprehensive tariff reform and commended the authorities for the recent adoption of an ordinance accelerating tariff reductions and reducing the number of tariff bands. Directors commended the authorities for eliminating the minimum duty values system and encouraged them to streamline the list of goods subject to a temporary additional rate and to consider further reductions in the maximum tariff rate.

Directors stressed the importance of further restructuring the banking system, strengthening bank supervision, and modernizing the payments system. They also put emphasis on other structural reforms, such as those pertaining to agricultural land, housing, and the judiciary. Directors recommended liberalization of most remaining administered prices, and the reinstatement of the periodic adjustment of domestic petroleum prices to reflect international oil prices and exchange rate fluctuations. They welcomed the authorities' measures to enhance transparency, and urged the strengthening of efforts to improve governance—including at the local and regional levels.

Directors welcomed the ongoing efforts to remove the data weaknesses that currently hamper the monitoring of economic conditions and formulation of economic policies. They urged the authorities to strengthen data coverage, quality, and timeliness, and to use the Fund's General Data Dissemination System (GDDS) as a framework for statistics development.

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

## 4. EUROPEAN CENTRAL BANK—INVITATION TO ATTEND EXECUTIVE BOARD MEETING

The Executive Directors agreed to invite Mr. Grisse, permanent representative of the European Central Bank in Washington D.C., to attend as an observer the upcoming Board discussions on Lithuania—Request for Stand-By Arrangement (Thursday, August 30) and Sweden—2001 Article IV Consultation (Friday, August 31).

## 5. EXECUTIVE DIRECTOR

The Acting Chairman bade farewell to Mr. Al-Faris on the completion of his service as Alternate Executive Director for Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Socialist

People's Libyan Arab Jamahiriya, Maldives, Oman, Qatar, the Syrian Arab Republic, the United Arab Emirates, and the Republic of Yemen.

**DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING**

The following decisions were adopted by the Executive Board without meeting in the period between EBM/01/84 (8/22/01) and EBM/01/85 (8/29/01).

**6. SOMALIA—OVERDUE FINANCIAL OBLIGATIONS—REVIEW FOLLOWING DECLARATION OF INELIGIBILITY—POSTPONEMENT**

The review of Somalia's overdue financial obligations to the Fund provided for under paragraph 5 of Decision No. 9575-(90/154), adopted October 26, 1990, as amended, is postponed to a date to be determined by the Managing Director, when in his judgment there is once again a basis for evaluating Somalia's financial and economic situation, the stance of its economic policies, and its cooperation with the Fund, and in any event not later than six months from the date of this decision." (EBS/01/142, 8/17/01)

Decision No. 12555–(01/85), adopted
August 24, 2001

**7. ZIMBABWE—OVERDUE FINANCIAL OBLIGATIONS—REVIEW FOLLOWING LIMITATION—POSTPONEMENT**

Paragraph 4 adopted on June 8, 2001 (EBS/01/67, Sup.1), shall be amended by replacing "September 8, 2001" with "September 30, 2001." (EBS/01/143, 8/20/01)

Decision No. 12556–(01/85), adopted
August 24, 2001

**8. SDR DEPARTMENT—DESIGNATION PLAN FOR SEPTEMBER–NOVEMBER 2001**

The Executive Board approves the SDR designation plan for the quarterly period September–November 2001 as set out in EBS/01/144 (8/20/01).

Decision No. 12557-(01/85), adopted
August 27, 2001

**9. FINANCIAL TRANSACTIONS PLAN FOR SEPTEMBER–NOVEMBER 2001**

The Executive Board approves the list of members considered sufficiently strong and financial transactions plan for the period September–November 2001, as set out in EBS/01/145 (8/20/01).

Decision No. 12558-(01/85), adopted
August 27, 2001

**10. POVERTY REDUCTION AND GROWTH FACILITY TRUST—BORROWING FOR LOAN ACCOUNT—CONSULTATION WITH CREDITORS**

The Managing Director, after having consulted with all creditors in accordance with Decision No. 12032-(99/87) PRGF, adopted August 2, 1999, is authorized to confirm that he does not intend to propose to the Executive Board borrowing of more than SDR 16 billion for the Loan Account of the Poverty Reduction and Growth Facility Trust except after consultation with all creditors regarding the justification for such additional borrowing and the adequacy of the Trust's Reserve in relation thereto. (EBS/01/132, 8/8/01)

Decision No. 12559–(01/85), adopted
August 23, 2001
effective September 23, 2001

**11. POVERTY REDUCTION AND GROWTH FACILITY TRUST INSTRUMENT—AMENDMENTS**

1. The following changes shall be made to the Instrument of the Poverty Reduction and Growth Facility Trust established by Decision No. 8759-(87/176) PRGF, adopted December 18, 1987:

(i) In Section II, paragraph 1(d), "December 31, 2006" shall be substituted for "December 31, 2001";

(ii) In Section III, paragraph 3, the following new sentence shall be added after the first sentence:

"The drawdown period under loan agreements to the Loan Account of the PRGF Trust for interim PRGF financing shall extend through December 31, 2009."

(iii) In Section III, paragraph 4(a), "August 31, 2001" shall be substituted for "November 30, 1993";

(iv) In Section III, paragraph 4(b), the following language shall be added after the second reference to "November 30, 1993,": "or prior to June 30, 2009, in case of a commitment under a loan agreement entered into after August 31, 2001,…"

(v) In Section IV, "paragraph 1(d)" shall become "paragraph 1(e)" and the following new "paragraph 1(d)" shall be added:

"(d) transfers from the Trust for Special PRGF Operations for the Heavily Indebted Poor Countries and Interim PRGF Subsidy Operations (PRGF-HIPC Trust) in accordance with Section III bis of that Trust Instrument; and…"

2. Paragraphs 1(iii) and 1(iv) of this decision shall become effective when all lenders to the PRGF Trust have consented to the changes proposed therein.

Decision No. 12560–(01/85), adopted
August 23, 2001
effective September 19, 2001

## 12. PRGF/HIPC TRUST INSTRUMENT—AMENDMENTS

The following changes shall be made to the Instrument of the Trust for Special PRGF Operations for the Heavily Indebted Poor Countries and Interim PRGF Subsidy Operations established by Decision No. 11436-(97/10), adopted February 4, 1997:

(i) In Section I, paragraph 1(vii), "December 31, 2001" shall be substituted for "December 31, 2000" and "2001/02-2006" for "2000/01-2004";

(ii) The following Section III bis shall be added after Section III:

**"Section III bis. Subsidies for Interim PRGF Operations**
For purposes of Section I, paragraph 2(b) of this Instrument, and to the extent that resources in the Subsidy Account of the PRGF Trust are insufficient for interim PRGF subsidy operations, the Trustee shall transfer to the Subsidy Account of the PRGF Trust, as needed, resources in the Trust Account not earmarked for assistance under Section III of this Instrument. Any such transfers shall be limited to the amounts needed for subsidy payments."

Decision No. 12561–(01/85), adopted
August 23, 2001
effective September 19, 2001

**13. APPROVAL OF MINUTES**

The minutes of Executive Board Meetings 01/16, 01/23, 01/26, and 01/27 are approved.

**14. EXECUTIVE BOARD TRAVEL**

Travel by Executive Directors, by Advisors to Executive Directors, and by an Assistant to Executive Director as set forth in EBAM/01/94 (8/24/01) is approved.

APPROVAL: November 26, 2001

SHAILENDRA J. ANJARIA
Secretary