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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 03/108

10:00 a.m., November 21, 2003

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

H. Köhler, Chairman
A. Krueger, Acting Chair
A. Carstens, Acting Chair

Executive Directors	Alternate Executive Directors
S. Al-Turki	A. Alazzaz
	A. Al Nassar, Temporary
	F. Vermaeten, Temporary
	E. Cunningham, Temporary
	C. Faircloth, Temporary
	H. Fabig, Temporary
	C. Harzer, Temporary
M. Callaghan	M. Reddell
	H. Jang, Temporary
	S. Boitreaud
	L. Duriez, Temporary
	C. Duriyaprapan, Temporary
	J. Salleh, Temporary
	T. Segara, Temporary
	B. Gulbrandsen, Temporary
	M. Nikitin, Temporary
	G. Sidlauskas, Temporary
N. Jacklin	M. Lundsager
	A. Baukol, Temporary
	I. Ábel, Temporary
	J. Jonas, Temporary
	L. Veziroglu, Temporary
	J. Costa, Temporary
	D. Vogel, Temporary
	A. Segura, Temporary
A. Mirakhor	M. Daïri
	S. Rouai, Temporary
A. Mozhin	A. Lushin
	S. Vtyurina, Temporary
	I. Zakharchenkov, Temporary
D. Ondo Mañe	T. Kudiwu, Temporary
	R. N'Sonde, Temporary
	R. Villavicencio, Temporary
	R. Calderón-Colín, Temporary
	M. Martinez, Temporary
P. Padoan	J. Santos, Temporary
	C. Cobos, Temporary
	C. De Silva, Temporary

B. Misra	R. Jayatissa
	D. Prasad, Temporary
	V. Srinivas, Temporary
	M. Brooke
	P. Williams, Temporary
A.S. Shaalan	O. Kanaan
	S. Bakhache, Temporary
	G. Shbikat, Temporary
I. Usman	P. Ngumbullu
	R. Gesami, Temporary
	Y. Patel, Temporary
	H. Ge
	X. Zhang, Temporary
	W. Zheng, Temporary
	A. Wong, Temporary
	Y. Yakusha
	H. Litman, Temporary
	T. Stucka, Temporary
	M.Kitahara
	S. Naka, Temporary
F. Zurbrügg	W. Szczuka
	O. Steudler, Temporary

S.J. Anjaria, Secretary
B. Esdar, Acting Secretary
A. S. Linde, Acting Secretary
Y. P. Chia, Assistant
T. Davidson, Assistant
J. Morco, Assistant
W. Rahman-Garrett, Assistant

Also Present
IBRD: P. Gupta, Senior Evaluation Officer; P. Kumar, Senior Country Economist; W. van Eeghen, Country Program Coordinator; L. van Gelder, Senior Country Economist. African Department: A. Bio-Tchane, Director; A. Basu, Deputy Director; K. Cheng, A. Fayolle, G. Kalinga, N. Maehle, C. McDonald, M. McIntyre, K. Thugge, D. Xie. Fiscal Affairs Department: T. Kalfan, R. Tchaidze. Finance Department: J. Honda. Legal Department: I. Mouysset. Middle East and Central Asian Department: G. Abed, Director; A. Bennett, E. Martin, R. Van Rooden. Monetary and Financial Systems Department: P. Brenner, M. Cihak, F. Fischer, G. Gasha. Office of Technical Assistance Management: S. Andrea, M. Fetherston. Policy Development and Review Department: L. Dicks-Mireaux, M. Fetherston, M. Fisher, M. Gilman, L. Aylward, I. Lokonga, T. Schneider. Secretary's Department: M. Miller, P. Ramlogan, J. Stotsky. Senior Advisors to Executive Directors: A. Ismael, J. Masawe, J. Milton. Advisors to Executive Directors: M. Abbing, D. Ayala, M. Barootchi, J. Borpujari, P. Dohlman, T. Farhadi, G. Francis, R. Gauba, J. Kwakye, T. Sekine, M. Sidi Bouna.

1. REPORT BY MANAGING DIRECTOR

The Managing Director reported on his travel to the Republic of Armenia, Republic of Tajikistan, Kyrgyz Republic, Russian Federation, and the Republic of Kazakhstan.

Length: 25 minutes

The Managing Director made the following statement:

> I would like to report to the Board on my visits to Armenia (November 10), Tajikistan (November 11), the Kyrgyz Republic (November 12), Russia (November 13), and Kazakhstan (November 14), where I met with the Presidents, their economic teams, and civil society. In Kazakhstan, I gave a speech at the Conference for the Tenth Anniversary of the Introduction of the Tenge. Also in Kazakhstan, I had bilateral meetings with People's Bank of China Governor Zhou Xiaochuan and Governor Managadze of the National Bank of Georgia. At the outset, I would like to thank the Armenian authorities, the Tajik authorities, the Kyrgyz authorities, the Russian authorities, and the Kazakh authorities for their very warm hospitality and the excellent arrangements they made for my visits.
>
> A number of key messages emerged from my discussions with the country officials:
>
> - The authorities appreciated the work of the Fund and were interested in deepening their cooperation with us.
> - Signs of progress were visible. Growth was strong in the last years but it still has not delivered improved living standards and reduced poverty on a broad basis. Progress has also been achieved in implementing reforms though, at times, political pressures resulted in slowdowns or reversals, raising the question of how solid was the social consensus for reforms.
> - The issue of regional impediments to growth and poverty reduction was raised in virtually every meeting. The authorities appealed to the international community to give it more attention and increase its involvement.
> - The authorities also expressed concerns about the situation in Afghanistan, which should attract more attention from the international community.

The main conclusions to draw out of these messages are:

- The IMF should stay actively engaged and give—together with the international community—even more attention to the challenge of regional cooperation.

- Better alignment of PRGF-supported programs and the countries' PRSPs is needed to ensure that growth is translated into sustained poverty reduction and improved income distribution. Our activities in this area will require a solid analytical base, which remains to be developed. I will ask staff to give this issue high priority.

- In the context of aligning the PRGF-supported programs and the PRSPs, greater attention will need to be given to the provision of adequate technical assistance, including on a regional basis.

A number of other specific issues were repeatedly addressed during my discussions with the various country authorities:

- Staying the course on policies necessary for macroeconomic stability;

- Preparing for future shocks by introducing "shock absorbers," such as flexible exchange rate regimes, appropriate social safety nets, and adequate budgetary reserves;

- Continuing energy sector reforms while paying due regard to the need to manage social consequences of increases in tariffs;

- Improving the business climate to attract FDI by having greater transparency and less governmental intervention and by tackling more forcefully the serious problems of corruption;

- Fostering the development of the financial sector to deepen the intermediation between savers and investors, and thereby ensure domestic sources of financing for SMEs; and

- For oil-exporters, developing a long-term strategy for the use of oil revenues that focus on human resources and public infrastructure that are needed to develop a vibrant non-oil sector.

Armenia

My first stop was Yerevan where I met with President Kocharian, Prime Minister Margarian, Minister of Finance and Economy Khachatrian and the Chairman of the Central Bank Sargsian. I also had a very interesting meeting with donors and NGOs. In the meeting with President Kocharian, I was impressed with his clear vision for his country. He recognized that

Armenia would continue to be affected by its geographical position although he hoped that artificial trade restrictions would be removed over time. Against this backdrop, he stressed the need for Armenia to develop a favorable investment climate, to facilitate SME financing, and to implement the anti-corruption strategy by the end of the year. I strongly shared his hope that the peace process would be revived which would allow resources currently devoted to military needs to be released for reconstruction and social needs.

Prime Minister Margarian associated himself strongly with the reform effort, especially the implementation of the PRSP and the anti-corruption strategy. He regretted the effects of the closure of the border with Turkey on Armenia's economic development and expressed his government readiness to initiate economic relations without necessarily settling all outstanding issues. While the Armenian officials were pleased with their recent economic performance, I detected no complacency. Instead, they recognized the very serious challenges they faced, especially the pervasive poverty in rural areas. There was a general awareness that the problem of corruption was a serious obstacle. Despite the favorable macroeconomic outcomes, the authorities saw the need for continued close relationship with the Fund under the PRGF. They agreed that the priority in the period ahead should be given to improving tax and custom administration and implementing consistently the PRSP. In my meeting with the donors and NGOs there was a lively exchange of views on the issue of poverty, including on the need to understand better the links between growth and poverty and to be able to monitor the poverty situation on a current basis.

Tajikistan

My second stop was in Dushanbe where I met with President Rakhmonov, and the economic team comprising State Economic Advisor Kholboboev, Minister of Finance Najmiddinov, Minister of Economy Saliev, and Chairman of the National Bank of Tajikistan Alimardonov. I also met with a group of ambassadors and NGOs.

In my meeting with President Rakhmonov, I was encouraged by his strong personal commitment to the reforms. He described concrete problems faced by his landlocked country and its citizens in trying to establish reliable transit trade routes within the region. This was a case of a country that wanted to take advantage of the opportunities offered by globalization but was finding it difficult owing to its geography and a lack of regional cooperation. He also noted the tensions that originated in Afghanistan and called on the international community to intensify its involvement in that country. He expressed strong interest in joining the WTO based on a schedule that would not leave Tajikistan behind its major trade partners, such as Russia.

While the Tajik officials were pleased with the recent performance of the economy, they agreed that the implementation of monetary policy should be strengthened. They clearly saw the need for deepening structural reforms, though they also emphasized that greater flexibility was needed in the aftermath of the civil war in setting out the timetables. They requested additional technical assistance, including with the restructuring of external debt. I acknowledged that structural reforms were difficult but also noted that, given the widespread poverty in the country, the authorities had no choice but to persevere. There was agreement on the reform priorities of focusing on the banking, energy, and the agricultural sector. I pointed out that the development of a vigorous private sector as a generator of jobs was not possible as long as government interference and an uneven playing field for taxpayers were the norm. Thus, the issues of improving the business climate, governance and civil service reforms were very urgent.

The Kyrgyz Republic

My third stop of this trip was Bishkek where I met President Akaev, Prime Minister Tanaev, Chairman of the National Bank Sarbanov, First Deputy Minister of Finance Toromurzaev, and parliamentary leaders. In addition, I met with a group of ambassadors and, separately, with some major foreign investors. President Akaev described his vision for his country's future and his policy priorities: dealing with the problem of corruption, reducing the country's very high external debt burden and improving regional cooperation, especially on trade. He agreed that given his country's geography, the investment climate it offered had to be seen as extremely competitive. In this context, improving governance across the board was of the highest priority. The President hoped that the second stage of the debt strategy—the Paris Club debt stock relief—would proceed on schedule for which the cooperation of bilateral creditors would be essential. On regional cooperation, while the President saw some signs of progress, he also saw an ideal opportunity for the international financial institutions to jointly assist the countries in removing the regional obstacles to growth.

The Kyrgyz officials emphasized the need to accelerate the growth of the economy as the only feasible way of eradicating poverty. Macroeconomic stability was seen as a key precondition for growth and in this context, they assigned an important role to continued fiscal consolidation based on strengthened revenue performance and better expenditure prioritization. They acknowledged the importance of improving governance, especially in regard to civil service reform and the judiciary. In this context, it was noted that judicial uncertainty was identified as a key weakness in a recent FSAP review. I stressed that the Kyrgyz Republic, as a geographically isolated country with few natural resources, could only compete for FDI on a basis of an excellent investment climate. In addition to FDI, it was also necessary to develop domestic sources of finance. I commended the authorities for the broad-based

PRSP process but noted that continued ownership would be important to translate policy intentions into actual progress on the ground. In regard to ownership, I was very encouraged by my meeting with the parliamentarians who expressed a strong commitment to reforms while also noting the existence of pressures from political forces that were critical of the Fund.

Russian Federation

The fourth stop of the trip was Moscow. There, I met with President Putin and CBR Governor Ignatiev. President Putin noted the importance of continued close contacts between his country and the Fund, notwithstanding the fact that Russia was no longer using Fund resources. I congratulated him on Russia's strong economic performance; to sustain it, I also emphasized the importance of maintaining macroeconomic stability and staying the course of structural reforms. In this context, I raised our concerns about the stance of fiscal policy, which looked better than it was owing to the high oil price. I also mentioned the need to tighten monetary policy to contain the upward pressures on core inflation. Against the backdrop of President Putin's goal of doubling GDP in 10 years, I reviewed our assessment of the status of structural reforms noting that, while there was progress in some areas (tax, land, labor, and judiciary), not much has been done in the key area of diversifying the economy and letting the crucial SME sector take off. This underlined the importance of pursuing civil service reforms, reducing government interference, reforming natural monopolies, and increasing competition. In particular, the underdevelopment of the financial system in terms of its intermediation potential was proving costly to the economy. I was very encouraged to hear that President Putin shared our assessment of the state of the economy and of the structural priorities. He acknowledged that there was a slowdown in reforms, owing to the upcoming elections, but stated that the overall reform strategy was firmly in place.

As regards the so-called "Yukos" affair, the President noted, on the one hand, the seriousness of the allegations especially concerning tax fraud and evasion and the need to ensure that no one would be seen as being above the law. On the other hand, the President touched on the widespread perceptions of arbitrary government actions. In this connection, he stressed that the allegations would still need to be proved in open court. The objective of the authorities was to apply the existing law in a uniform, transparent, and predictable manner. Moreover, there would be no reversals of privatizations. As regards Russia's international relations, the President noted with concern the situation in Afghanistan; he also associated himself with efforts to improve regional cooperation in Central Asia. I was also gratified to hear President Putin's assurances that his government would cooperate with the international community in dealing with Iraq's external debt problem. Finally, with Governor Ignatiev, I discussed the risks to the inflation target, the scope for tightening monetary policy, and especially the possible avenues for fostering the needed strengthening of banking supervision.

Kazakhstan

The last stop of the trip was Almaty. There I addressed the Conference for the Tenth Anniversary of the Introduction of the Tenge (posted on the IMF website). The Conference was also addressed by a number of other speakers. In this connection, I want to single out the very frank and professional presentation by the Governor of the People's Bank of China on the challenges faced by the financial system in his country. I liked, in particular, the conclusion that financial sector "reform is an art, and a game." I also held bilateral meetings with President Nazarbaev, Deputy Prime Minister Pavlov, and Governor of the NBK Marchenko. My meeting with President Nazarbaev took place shortly after his return from a trip to Singapore, the Philippines, and South Korea, which he described to me as part of his effort to keep abreast of, and learn from, developments in the dynamic economies of Asia. I was greatly encouraged by the President's specific plans of using the oil wealth for investing into Kazakhstan' human resources, concentrating on rural areas where the needs were the most acute, with housing, water supply, hospitals and schools as the priority areas. The President was well aware of the danger of the "natural resource curse" and stressed that economic decision-making in most areas will proceed as if the oil wealth was not there. As for regional cooperation, he was personally well acquainted with the problems that the countries of the region faced in developing their trade relations and encouraged the international financial organizations to work with the countries to lessen them.

Against the backdrop of strong growth and falling poverty levels, I found the Kazakh officials well aware that the large inflows of oil revenues presented opportunities but also large risks. So far, the management of the oil wealth has been prudent and the handling of the macroeconomic challenges stemming from the strong balance of payments position has been quite skillful. Looking ahead, the banking system will need to be developed further to play its role in the development of domestic sources of financing. In this context, I stressed the need for forceful and independent bank supervision and for broad transparency as a guiding principle for public policy, especially in regard to the oil sector.

Lastly, let me again thank the authorities in all five countries for their very warm and generous hospitality, as well as Messrs. Kiekens, Kremers, Mozhin, and Zurbrügg. I also appreciate the hard work of the staff, who supported me throughout the trip. I will be sending a copy of my report to UN Secretary-General Kofi Annan, President Wolfensohn of the World Bank, President Lemierre of the European Bank for Reconstruction and Development, and President Chino of the Asian Development Bank. I would,

> after this trip, like to again take the initiative in making the different multilateral institutions discuss better regional cooperation and how we can all contribute to this objective.

Mr. Kremers thanked the Managing Director for his visit to Armenia, which gave a boost to his authorities and to their relationship with the Fund. His authorities very much appreciated the emphasis that the Managing Director placed on the Fund's role in smaller countries, including his emphasis on extending equal treatment to both small and large countries.

Mr. Zurbrügg said that his Kyrgyz and Tajik authorities also very much appreciated the Managing Director's emphasis on small countries. His authorities hoped that the short but intense visit had given the Managing Director a good appreciation of the problems on the ground. The longstanding cooperation between the Kyrgyz authorities and the Fund had established the credibility of Fund advice.

Mr. Mozhin thanked the Managing Director for his visit to Russia. His authorities believed that it was important to maintain dialogue with the Fund at all levels, including at the highest political level.

Mr. Prader said that his Kazakh authorities highly appreciated the Managing Director's visit. The visit had shown that the Fund recognized the country's accomplishments. His authorities had consistently emphasized regional issues, and were gratified that the Fund had also recognized them.

2. INTERNATIONAL ADVISORY AND MONITORING BOARD FOR IRAQ—APPOINTMENT OF REPRESENTATIVE BY MANAGING DIRECTOR

Length: 15 minutes

The Managing Director made the following statement:

> I wish to inform the Board that the UN Secretary-General has sent me a letter stating that he would now move to formally establish the International Advisory and Monitoring Board (IAMB). As you are aware, UN Security Council Resolution 1483 of May 22, 2003, provides for the establishment of an International Advisory and Monitoring Board, the purpose of which is to ensure "that the development fund for Iraq is used in a transparent manner to meet the humanitarian needs of the Iraqi people, for the economic reconstruction and repair of Iraq's infrastructure, for the continued disarmament of Iraq, for the costs of Iraqi civil administration, and for other purposes benefiting the people of Iraq." Further, the terms of reference of the IAMB also state that it will "ensure that the export sales of petroleum, petroleum products, and natural gas from Iraq are made consistent with prevailing international market best practices." The four members of the Board are the representatives of the Executive Heads of the International

Monetary Fund, the World Bank, the Arab Fund for Economic and Social Development, and the United Nations.

The UN Secretary-General has sent me a letter announcing that he intends to convene a meeting of the IAMB on Friday, December 5, at 11:00 a.m., at the United Nations Headquarters. He has given me the name of his representative on the IAMB: Mr. Jean-Pierre Halbwachs, Assistant Secretary-General and Controller. My job is to also appoint my representative in the IAMB. Given the IAMB's function, I have concluded that Mr. Bert Keuppens, currently Senior Advisor in the Finance Department and formally the Chief of the Accounts and Financial Reports Division, is best qualified to represent me on the IAMB. Accordingly, I intend to appoint Mr. Keuppens as my representative, with Mr. Christopher Hemus, currently Deputy Chief of the Safeguards Assessment Division, as his Alternate. They will attend the meeting on December 5 in New York.

3. ANNOUNCEMENT BY MANAGING DIRECTOR

Length: 15 minutes

The Managing Director made the following statement:

I would like to take this opportunity to inform Executive Directors that I have decided on the following senior appointments in the Fund.

I have selected Mark Allen to succeed Tim Geithner as Director of the Policy Development and Review Department (PDR). In keeping with standard practice, the N-12 announcement for this appointment will be issued shortly with the normal circulation period. I would like to share with you some of the critical inputs in my decision to appoint Mr. Allen to this position.

When I met with you on October 22 to discuss the background and competencies for the position of the next Director of PDR, there was broad support among Executive Directors that we should seek an individual with strong analytical abilities, significant insights into the work and policies of the Fund, and a proven record of strong leadership and interpersonal skills. Executive Directors also indicated that, in their view, such a candidate should possess the ability to contribute to fresh ideas in taking the policy agenda of this institution forward. After reflecting on your views, I indicated to you on October 29 that the qualified pool of potential candidates within the Fund was sufficiently deep to select the next Director of PDR from within this institution. Throughout the process, I have greatly benefited from the wise counsel of my own colleagues in the management team.

I am happy to say that Mark Allen embodies these qualities and I see him as someone who is well prepared to take on this challenging assignment.

As you know, Mark is an outstanding economist, with broad policy and country experience in several different departments of the Fund. In my view, this experience, as well as his intellectual independence, makes him eminently qualified to build upon our existing policy framework and develop new ideas on how to further adapt our policy agenda in an ever-changing global environment. I really think that he is up to the job, and I personally look forward to working with him.

I have also selected Leslie Lipschitz to succeed Mohsin Khan as Director of the IMF Institute. Again, in keeping with standard practice, the N-12 announcement for this appointment will be issued shortly with the normal circulation period. I would again like to share with you some of the critical inputs in my decision to appoint Mr. Lipschitz to this position.

When I met with you on August 1 to discuss the background and competencies for the position of the next Director of the IMF Institute, there was broad consensus among Executive Directors that we should seek an individual with significant exposure to the work of the Fund; familiarity with its policies, mandates, and operating procedures; and an effective and experienced communicator who can effectively interact both within the Fund and with member countries. Executive Directors also indicated that, in their view, such a candidate should possess strong policy-oriented experience and not a uniquely academic background. After reflecting on your views, management considered both internal and external candidates for this position. Throughout the process, I have greatly benefited from the advice of my own colleagues in the management team.

I am happy to say that Leslie Lipschitz is, in my view, the best candidate to take the important work of the IMF Institute forward. As you know, Leslie is an outstanding economist, deeply versed in Fund policies. This experience, together with his intellectual firepower and energy, provide an excellent basis to transmit the work of the Fund to its training and capacity-building activities, and also to be a continuous contributor of fresh ideas into the Fund. So, I personally do think that we will see a continuation of good work from the Institute that we have experienced in the past.

Messrs. Shaalan, Usman, and Prader, and Ms. Jacklin welcomed the Managing Director's appointments, and looked forward to working with Messrs. Allen and Lipschitz in their new capacities.

4. KENYA—POVERTY REDUCTION AND GROWTH FACILITY—THREE-YEAR ARRANGEMENT; AND POVERTY REDUCTION STRATEGY PAPER PREPARATION STATUS REPORT, AND JOINT STAFF ASSESSMENT

Documents: Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility (EBS/03/151, 11/10/03; Cor. 1, 11/20/03; and Cor. 2, 11/21/03); Debt Sustainability Analysis (SM/03/373, 11/18/03; and Cor. 1, 11/20/03); Poverty Reduction Strategy Paper Preparation Status Report (EBD/03/107, 11/10/03); and Poverty Reduction Strategy Paper Preparation Status Report—Joint Staff Assessment (EBD/03/108, 11/10/03)

Staff: Kalinga, AFR; Fetherston, PDR

Length: 1 hour, 45 minutes

Mr. Usman submitted the following statement:

Key Issues

- The authorities have implemented all the governance measures that had not been undertaken under the previous arrangement.

- They have prepared a paper on a three-year Program of Economic Reform Strategy for Wealth and Employment Creation (ERSWEC) that incorporates a medium-term economic strategy to drive the economic recovery process, and later convert into a full PRSP after detailed discussions and after undertaking the consultative process.

- The main elements of the new program to tackle poverty include a reform of the agricultural sector, the growth of medium- and small-scale enterprises, rehabilitation of rural health facilities, and the expansion of the role and capacity of local governments. There are also other far-reaching policies to address vulnerabilities in fiscal consolidation, monetary management, and international competitiveness, including incentives for private sector participation.

- To implement the economic program effectively, the Kenyan economy will need increased assistance from donors to bridge the financing gap in the external sector.

Introduction

My Kenyan authorities express their appreciation to the management and staff of the Fund for their understanding and support in their efforts to establish a realistic and sustainable economic policy framework that will reverse the many years of low growth and rising poverty. In particular, they acknowledge the invaluable contributions of the staff towards the preparation of the Economic Recovery Strategy for Wealth and Employment Creation paper, which forms the basis for the current economic development program and the medium-term strategies.

The Kenyan authorities have implemented all the governance measures that had not been undertaken under the previous arrangement, in addition to the prior actions in the relevant areas identified in the last Article IV staff report.

They have also prepared and begun to implement a three-year development strategy in the form of an Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC), which outlines a broad-based agenda consistent with their memorandum of economic and financial policies (MEFP) to tackle Kenya's deep-seated economic problems.

This strategy will later be expanded into a full PRSP after a detailed discussion of the various dimensions of poverty, the medium-term expenditure framework, and the consultative process.

The macroeconomic framework contained in the program is consistent with the measures and policies underpinning the proposed PRGF-supported program.

With these efforts, the authorities hope that their request for the PRGF-supported program will be favorably considered.

Recent Economic Developments

The GDP growth rate for 2003 is projected at about 1.3 percent, owing to many delimiting factors faced by the authorities in implementing economic development programs during the year. These include the negative impact on tourism, of the recent terrorism-related incidents. Tourism is one of the major sources of revenue for the economy. Consequently, government revenue fell sharply, the overall deficit before grants widened, and domestic borrowing remained high.

However, the external current account deficit (before grants) narrowed significantly, while the inflation rate fell from 5.9 percent to 2.7 percent, resulting in a decline in the treasury bill rate. There are indications that horticultural and manufacturing exports, which grew at annual averages of 23 percent and 36 percent, respectively, in the three years up to 2002 will continue to perform well and remain competitive. In the meantime, the

2003/04 budget, which was passed in August 2003, is consistent with the macroeconomic framework of the new program.

Reforms Undertaken

The authorities have continued to enhance their reform program and to place governance, and particularly, the anticorruption strategy at the top of their reform agenda. In this regard, they have embarked on major strengthening of governance and anti–corruption institutions. The following are the additional measures that have been undertaken since the last staff mission:

- Implementation of Public Officer Ethics Act under which all public officials, including the executive and legislative arms of government and the military were to complete the declaration of their assets and those of their families by Dec 2003.

- Seminars and workshops on corruption prevention are being organized for civil servants at all levels.

- The police force has been reorganized, while an action plan has been initiated with the assistance of the World Bank and other donor agencies to strengthen the judiciary under a newly appointed Chief Justice.

- A draft listing of pro-poor expenditures for both recurrent and development expenditures has been completed, which contains priority programs per sector, and linked to their budget codes to facilitate the tracking of the key programs. Since early this year, the government has embarked on monitoring, on a quarterly basis, a set of these core poverty programs.

- Comprehensive program of public finance reforms that will incorporate the recommendations made by the 2003 public expenditure management mission has been prepared, while a variety of measures are being designed to improve the customs clearing system and the efficiency of customs administration in order to facilitate trade.

- A committee has been set up to advise on new mechanisms for determining the wages of civil servants.

- A Privatization Commission has been established to accelerate the privatization process and manage the divesture program.

- The Central Bank of Kenya has made notable progress in strengthening its operations since the December 2000 safeguards assessment. The bank has improved on the internal audit function and has adopted an external audit rotation policy by appointing a new external audit firm to replace the old one. The pending issues on government transactions and on regularizing frozen government loan accounts have also been resolved.

Main Elements of the Economic Reform Strategy for Wealth and Employment Creation (ERSWEC)

The Kenyan authorities' development strategy, as outlined in the ERSWEC, is part of a broader economic agenda that is supported by donors and development agencies, including the World Bank. The program contains a package of policy measures that will address the identified economic problems of low growth, low savings and investment, poor public service, large domestic debt, distortions in the financial system, unemployment, and poverty.

Embedded in the program are core poverty expenditures, which are derived from specific development targets that include, among other measures, improving access to primary education, providing safety nets such as training programs for urban unemployed youths.

More specifically, the following are the policy measures being adopted to achieve the set objectives:

Measures to address poverty—The program identifies that most of the poor live in rural areas, and as a result it focuses on reforming the agricultural sector and encouraging the growth of medium and small scale enterprises, while plans are underway to upgrade microfinance institutions. In addition, there are measures to tackle the high prevalence of HIV/AIDS in rural areas, including the rehabilitation of rural health facilities to positively affect agricultural productivity and rural incomes. Another important element of the rural development strategy and to lay the basis for the implementation of the poverty reduction program, is that the role of local governments is being expanded, and it is proposed that the proportion of local authorities' spending will be raised to at least 20 percent of total expenditure by 2018. Their revenue base and their budget management and program implementation capacity will also be strengthened.

Fiscal program—Domestic debt restructuring is a central element of the fiscal program, which aims at debt sustainability and making the government a net contributor of resources to the banking system, without compromising the provision of increased resources for priority poverty reduction spending and for contingent liabilities. To this end, measures at fiscal restructuring and improving public expenditure management (PEM) are important elements of the program. These include, reductions in the wage bill through revised modalities for setting public wages and other entitlements, increasing spending on priority social and economic outlays, reform of all public sector procurement systems, relating the annual budgets to the medium-term expenditure framework, and adopting enhanced modalities for monitoring, tracking and reporting of budget operations, particularly poverty spending.

International competitiveness—will be addressed through reforms in the utility and telecommunications sectors, in external trade and the labor market, as well as upgrading of infrastructure. Trade reforms in the medium term will focus on lowering the external tariff from 35 percent to 15 percent and the number of tariff bands from 5 to 3, which are consistent with the agreement of the East African Community (EAC) customs union, as well as reducing the current export incentive scheme. It is estimated that improved tax administration under the program would result in reduction in smuggling and a substantial increase in revenue to facilitate a more ambitious reduction in tariff. The authorities intend to retain the current floating exchange rate regime, and are committed to making full use of the exchange rate flexibility to respond to exogenous shocks.

The medium term outlook of the program—proposes more broadly based growth, reflecting higher productivity and capital accumulation from reforms in the parastatal and financial sectors and labor markets, as well as from improved terms of trade. Spending on essential social and economic services will rise from 3.4 percent to 4.6 percent. Overall, real GDP growth is forecast at 1.9 and 3.9 percent in 2003/04 and 2005/06, respectively, from the current level of 1.2 percent.

The growth rates are to be driven by increased activities in all the major sectors of the economy, as well as in private sector investment. Underlying inflation will remain at 5 percent, with a modest buildup in reserves to about 4.0 months of projected import cover by end-June 2006. The inflation objective is to be achieved through reserve money targeting, with broad money as the intermediate target and open market operations as the main instruments. The Central Bank of Kenya will continue to use a broad set of indicators to monitor future inflationary pressures and to gauge the appropriateness of the monetary policy stance.

The approved budget for 2003/04 envisages an increase in total revenue collection by 1.5 percent of GDP and aims at a substantial reduction in the domestic borrowing from 5.0 percent to 3.3 percent of GDP, consistent with the objective of debt sustainability under the ERSWEC. It is estimated that the increase in revenue will more than offset the revenue losses arising from the reduction in VAT rate from 18 to 16 percent and excise duty from

15 percent to 10 percent. Expenditure is projected to rise by 2.0 percent of GDP during the year, in line with the new program and consistent with increases in pro-poor social spending and other public outlays, and capital spending.

Proposed Reforms to Facilitate Implementation of the ERSWEC

My authorities are aware of the challenges they may face in implementing the program and they have noted the staff's comments and recommendations for addressing them. In this regard, in addition to the reforms already undertaken and those that are ongoing, they have identified and incorporated into the ERSWEC program, other policy measures that will be needed to pre-empt many of the risks and vulnerabilities. These additional measures would include:

- Transferring financial sector regulatory functions from the Ministry of Finance to the Central Bank of Kenya. In addition, the authorities intend to bring major revisions to the Banking and Central Bank of Kenya Acts before the Parliament by June 2005. There will also be reforms on addressing the major weaknesses in the financial system with focus on banks in distress and a strengthening of the financial system, especially concentrating on the main problems that have given rise to nonperforming loans.

- The authorities will initiate new anti-money laundering legislation that will reflect all relevant recommendations from the Bank-Fund FSAP assessment report for Kenya.

- The Kenya Anti-Corruption Commission (KAC) with five regional offices will be established shortly, following the enactment of the Act in 2003, and the endorsement by Parliament of the KACC Advisory Board.

- A plan has been devised to clear the stock of pending bills and resolve the problem of stalled projects.

- A bill for the transparent privatization and sale of public assets is already before the Parliament.

- In addition to reforms in customs administration, plans are underway to implement a comprehensive tax reform that will improve tax administration and broaden the tax base, through removal of exemptions and through taxation of larger proportion of informal transactions. The authorities are also planning to institute new modalities for managing the taxation of the petroleum sector.

- On statistics, the authorities are taking appropriate actions, with the assistance of donors, to improve the quality and timeliness of data in the areas of the budget, foreign trade, and national accounts.

Need for Donor Support

Medium-term projections indicate that there will be external account gaps in implementing the new program arising from an envisaged pickup in government outlays on social and economic infrastructure and other public investment programs. These outlays will put substantial pressure on the external current account. The deficit on the external current account is estimated to widen to 4.9 percent of GDP in 2003/04, with the prospect of rising further to 11.0 percent of GDP by 2005/006. Consequently, the program will require a marked increase in donor assistance from 6.5 percent of GDP to 9.9 percent in 2005/06 to support its implementation. Total financing needs are projected to average about $1.3 billion per year through 2005/06. Program support and Paris Club rescheduling are expected to fill the financing gap during the period. The authorities have indicated their intention to seek a rescheduling from the Paris Club and are currently discussing with their key creditors and donors on possible Paris Club rescheduling terms.

Conclusion

My authorities wish to reiterate their strong political will and commitment to revive the Kenyan economy and put it back on the path of sustainable and job creating growth and poverty reduction. They hope they can continue to count on the sustained understanding and support of the Fund and the rest of the international community in the form of timely and adequate financial support, advice, and technical assistance in the relevant areas to achieve these objectives.

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

Economic performance in Kenya over the past several years that covered the just-expired PRGF arrangement has been beset by many deep-rooted structural weaknesses and poor implementation and governance. While the decline in tourism has been an important factor behind the recent sub-par growth of the country, the persistent slow pace of reforms prevented economic activity from reaching its potential. In fact, per-capita income declined to less than its level a decade ago and to well below the average for sub-Saharan Africa. Over half of the population is now living below the poverty line. Along with these developments, the fiscal position has also deteriorated, with accumulating arrears and mounting recourse to domestic financing to substitute for donor support, which was sharply curtailed as a result of poor implementation of reform measures. In spite of these adverse developments, some macroeconomic indicators, particularly the exchange rate and, in recent months, underlying inflation, have experienced noticeable stability following considerable pressures.

Against this background, there are indications that the authorities are making a decisive attempt to break with the past record of uneven performance. As highlighted in Mr. Usman's helpful statement, the authorities have put in place and initiated the implementation of wide-ranging structural reforms under the new development strategy, ERSWEC, to lay the ground for strong economic and employment growth and poverty reduction. Important progress in improving governance has been achieved and the fight against corruption remains a top priority in the period ahead. We believe that the strategy outlined in the staff report forms a good basis for a successor PRGF-supported program, which is critical to support Kenya's reform efforts and help restore investor confidence and regain the much-needed donor assistance. The latter is crucial and, in our view, poses the main risk to the proposed program as many of the key targets, particularly the reduction in domestic borrowing at a time of increasing investment and social outlays, and the build up in foreign reserves are based on the assumption of securing adequate external financing. The dependence of donor support on the implementation of reforms makes it all the more important that the authorities strictly adhere to their economic program, which would hopefully lead over time to a reduction in the heavy reliance on external financing. On a more general point, we have noted in reviewing the many PRGF-supported program papers presented to the Board that one of the issues that needs to be accorded more attention is the adequacy of the implementation capacity in relation to the policy requirements of the program. The latter in many cases far exceeds the implementation capacity, thereby endangering the success of the program. Notwithstanding this caveat, we can support the request for a new PRGF arrangement, and will focus the remainder of our comments on key fiscal and monetary issues, as well as some important aspects of the structural reform agenda.

The focus of the fiscal program on restoring debt sustainability and increasing resources for capital and social spending is appropriate. To this end, the 2004 budget envisages a substantial decline in domestic borrowing and a sizeable budgetary allocation for education and infrastructure spending. We welcome the ambitious, but achievable, targeted increase in revenue and the focus on rehabilitating the capacity and integrity of the tax administration. This will pave the way for further reforms in the medium term, particularly expanding the tax base, removing exemptions, and reducing some tax and tariff rates. On the expenditure side, it is important to curtail non-essential current spending, including the wage bill, in order to free resources for higher priority social and economic outlays. We very much welcome the measures taken and planned to improve public expenditure management, notably with regard to the poverty tracking system, budget formulation, execution, and reporting, including strengthening the Commitment Control System. It is important that these efforts be also directed at local governments, particularly given the plan to shift some spending responsibilities to them.

It is increasingly evident that improved governance is essential for the success of these revenue and expenditure efforts. The authorities should remain steadfast in implementing the anti-corruption strategy, including by establishing the Independent Anti-Corruption Commission and enforcing the recently enacted Anti-Corruption and Economic Crimes Bill and the Public Officer Ethics Bill. This action would constitute a building block in restoring confidence—so essential to enhancing the activities of the private sector.

On monetary policy, while inflation remains low, current conditions merit increased vigilance by the authorities. The high level of liquidity in the banking system coupled with low interest rates on treasury bills reduces the effectiveness of monetary policy in controlling credit and monetary aggregates. Therefore, the central bank is encouraged to increase its repurchase operations to mop up this excess liquidity, and reverse the recent increase in reserve money in line with the set target. This is all the more important in view of the expected increase in volatility of the monetary aggregates in response to the changing economic environment and reforms under the program. In this connection, we particularly emphasize the need to carefully monitor the expected increase in capital inflows associated with higher donor support, which could also increase pressures on the exchange rate.

On structural reforms, resolute and swift actions are needed to address weaknesses in the financial sector. Priority in this regard should be accorded to lowering the high non-performing loans, reducing interest rates margins, strengthening bank capitalization, and enhancing bank supervision. On the latter, the amendment of the Banking and Central Bank Act to facilitate the transfer from the ministry of finance to the central bank of the regulation and supervision of banks is a step in the right direction. In addition, the privatization of large public banks, which have contributed significantly to the high levels of non-performing loans and interest rate spreads, would be a major step toward enhancing the soundness and efficiency of the banking system, and reducing the serious risk posed by the contingent liabilities on the budget.

Privatizing other key parastatals would not only reduce the burden on the government finance, but also eliminate inefficiencies in the economy and encourage private investment. In this regard, we welcome the authorities' plan to enact a law that will provide for the establishment of a Privatization Commission. The authorities are also encouraged to take note of the staff's suggestions , including in particular the importance of putting in place a transparent privatization mechanism, to avoid difficulties experienced in past divesture programs. We would like to emphasize that privatization per se is not an accomplishment; the manner in which privatization is carried out is what could make the process useful in attaining the programs' target.

With these comments, we wish the Kenyan authorities success in undertaking the challenging endeavors ahead of them.

Mr. Callaghan submitted the following statement:

Key Points

- The new administration has made a commendable effort at tackling the endemic corruption which has plagued the country.

- Addressing corruption is just the start, and the reform agenda necessary to revitalize the Kenyan economy is, however, substantial. The authorities will need a focused, prioritized strategy which has regard to capacity constraints and donor support.

- We support the program, although we note the risks involved.

Table 5 in the staff report starkly highlights the decline in social conditions in Kenya associated with the underperformance of the economy over the past decade: per capita GDP has declined, life expectancy has fallen by 10 years, primary school enrolment has fallen and, as noted in the MEFP, the number of people living below the poverty line has increased by nearly 6 million over the past ten years.

The opening sentence of the MEFP sums up the situation facing Kenya. It does stand at a critical juncture in its post-independence history and after two-and-a-half decades of one-party rule and deteriorating economic opportunities, the recent change in government has raised expectations that things will improve.

The new government has made a good start, and it is basically because of the commitment that the President has shown to tackling endemic corruption that a new program has been presented to the Board and that there is a high expectation of a return of donor support. Not only have there been institutional and administrative changes—such as the establishment of a Department of Governance and Ethics, the launch of the Public Complaints Office, arrangements for the establishment of KACC—there have been tangible signs of progress, particularly in cleaning up the judiciary. A High Court judge has been charged with corrupt activities and 42 judicial officers have either resigned or been dismissed on corruption-related suspicion. Mr. Usman's helpful statement provides an impressive listing of all the measures that have been taken. Action always speaks louder than words and the government will continue to be judged by its performance rather than by rhetoric and stated intentions.

It is appropriate that the government has placed its anti-corruption strategy at the top of its reform agenda, for without addressing corruption there will be no return of external funding, no improvement in the investment climate, no increase in FDI inflows and no pick-up in the economy. However, in many respects, addressing corruption is just the start of the efforts necessary in resurrecting the Kenyan economy. The staff report highlights the magnitude of the task facing the authorities. A key point in the JSA is the need for the authorities to clearly identify a limited number of priority actions that will have the greatest impact on growth and poverty reduction, given resource and capacity constraints. The staff note that one of the key risks to the program is an increase in tensions within the ruling coalition. Problems in the implementation of reforms as a result of insufficient preparation or capacity shortcomings are a good way to magnify political tensions.

We support the proposed program and will note a few issues.

The macroeconomic framework is critically dependent on the resumption of substantial donor assistance, including “expected but unidentified” program support. Contingency plans will be needed to address any shortfall in donor support.

Part of the fiscal restructuring involves a reduction in the wage bill through “revised modalities for setting public wages”. The wages’ share of total expenditure will be reduced in 2004/05 and 2005/06, however, there is significant additional expenditure for “civil service reform” which is projected to continue for many years. Further elaboration of the new wage setting mechanism would be appreciated, particularly given reports that expenditure on wages and salaries is unlikely to fall owing to the implementation of pay awards for civil servants which are considered necessary to reduce incentives for corruption.

The report notes that comprehensive tax reforms are underway to improve the neutrality, simplicity and revenue-yielding capacity of the system. However, there is only a very modest increase in revenue performance projected between 2003/04 and 2008/09. In fact, it is only in 2008-09 that the ratio rises materially above the 1989/90 level, even with the 1.2 percentage points of new measures. Moreover, a significant part of the increase in revenue is attributed to unspecified “new revenue measures”.

While protection has been reduced, Kenya is still suffering from relatively high and distortionary tariffs, along with cumbersome and inefficient customs procedures. Further reductions in the tariff rate will benefit the country but, as the staff note, a key concern are the revenue losses associated with trade liberalization. This reinforces the need to improve the overall revenue effort.

An important element of the development strategy is to raise the proportion of local authorities' spending. As the paper notes, to achieve this objective without compromising fiscal prudence will require actions to strengthen the local authorities' revenue base, budget management and program implementation capacity. This is easier said than done when the central government's capacity in all these areas is currently very weak. However, it will be important to ensure that the capacity of local governments is in fact strengthened prior to the decentralization of expenditure responsibilities.

The alignment of the national budget process with the ERS is a very positive move.

The staff appropriately note that while it is a commendable objective to want to address the distortions in the public sector through accelerating the privatization process, it is first necessary to strengthen the implementation capacity to achieve an effective and efficient privatization process.

Addressing the weaknesses in the financial system will be a complex and challenging task. Careful prioritization of the reform agenda will be essential.

We wish the authorities all the best in meeting the enormous challenges ahead.

Mr. Steiner and Mr. De Silva submitted the following statement:

We thank the staff for a comprehensive report and Mr. Usman for his helpful statement.

In the wake of the momentous and remarkably smooth political transition of just under a year ago, Kenya has embraced a new era of positive change marked by a strong and clearly demonstrated commitment to the goals of revitalizing the economy and attacking widespread poverty. Recent economic performance has been characterized by lackluster growth and stubbornly high fiscal deficits which have been associated with expanding debt and declining levels of gross international reserves. The weak economy has severely limited Kenya's capacity to even hold the line on deteriorating social conditions. As Table 5 of the staff report shows, Kenya has lost considerable ground in the effort to sustain and improve the living standards of its population, with key social indicators pointing to drastic reversals in fundamental areas such as life expectancy, school enrollment and the prevalence of HIV/AIDS. Nevertheless, the efforts of Kenya's new administration have created a credible climate of reform which has substantially restored the confidence of the international community and made a strong case for the resumption of international financial support, including that of the Fund.

The proposed PRGF arrangement represents an ambitious strategy for halting Kenya's downward social and economic slide. Governance issues have in the past been a major stumbling block to progress and the Kenyan authorities are keenly aware that strong and credible action on this front will be necessary to ensure that the required level of donor support, on which the success of the program is crucially premised, will in fact be forthcoming. Impressive gains have already been made in strengthening the institutional anti-corruption framework, including the passage of key legislation and the establishment of a new ministry with a strong anti-corruption mandate. In addition, forceful investigative and prosecutorial action has been initiated against public officials suspected of corruption. The government will need to stay the course on this potentially divisive issue which will remain a critical test of its commitment to reform and a key to further improving relations with the international community.

The new administration faces the demanding task of restoring the economy to the path of sustainable employment-generating growth. As a first priority this will require resolute implementation of measures to correct macroeconomic imbalances. At the same time, action is needed to strengthen a weak financial system and to restructure the trade regime to improve external competitiveness. The medium-term fiscal program correctly focuses on plugging the budgetary financing gap and creating the conditions for a return to debt sustainability. The approach is well balanced, consisting of a practical and realistic mix of reform measures aimed, on the revenue side, at improving tax administration and broadening the tax base and, on the expenditure side, at cutting wage expenditure to make way for priority social spending, and strengthening expenditure management and control systems. The program appropriately maintains the focus of monetary policy on inflation control, which has been one of the successes of macroeconomic management over the last three years. Nevertheless, there appears to be significant room for growth supportive increases in domestic credit.

Kenya's financial system is fragile and it is essential that vulnerabilities in this key area be addressed quickly to avoid undermining the broader economic recovery strategy. The transfer of licensing, regulatory, and disciplinary authority over the banking system from the ministry of finance to the central bank is an important step in the right direction but this enlargement of its role could itself place a significant burden on the central bank's existing capacity. Concomitant action may therefore be needed to place the central bank on a suitably strong footing to take on its expanded responsibilities. The reform agenda outlined in the program is comprehensive and appears to be a well-targeted response to the wide ranging problems identified in the sector. Nevertheless, the results of the ongoing FSAP will provide a useful basis for refining this response and for enhancing the effectiveness of financial sector reforms.

The government's decision to move to the elaboration of a full PRSP in the coming months is welcome, and a reminder of the pressing need to keep poverty reduction at the center of efforts to foster growth and development of the economy. The poverty reduction agenda outlines an impressive menu of measures which will have their major impact in the medium-term, but it is important that short-term poverty alleviation also be kept high on the agenda.

As the staff notes, the proposed PRGF-supported program for Kenya is not without risks, not the least of which stems from potential divisions within the ruling coalition. Nevertheless, we share the staff's view that the strength of Kenya's program and the country's record of implementation of prior actions constitute strong recommendations for approval of the program. We therefore support the program and wish the authorities success in meeting their future challenges.

Mr. Le Fort and Mr. Segura submitted the following statement:

We would like to thank the staff for the well-focused reports and Mr. Usman for his candid statement. At the outset, we would like to express our support to the proposed decision. Despite the major setbacks on implementation of structural reforms under the previous PRGF arrangement since 2000, due to political opposition from the Parliament, the Judiciary, and even the Cabinet, the new administration that took office in 2002 seems committed to pushing forward a comprehensive economic program contained in its Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC). An early indication of such commitments is the fulfillment of all prior actions that enable the Board to consider the request for a new three year PRGF arrangement.

The country's medium-term strategy summarized in the status report on the Economic Recovery Strategy (ERS), being based on an important part on the past PRSP, constitutes a sensible, albeit still preliminary, framework on which to base the efforts to reduce poverty. While we would be more comfortable to wait until the ERS is finalized to consider the request for a new PRGF, we understand the urgent needs that the country faces, among them, the need to gather considerable international support in the form of increased concessional resources and grants, to bridge the large financing gaps. To this end, the PRGF is a valuable conduit, given the forthcoming Consultative Group (CG) meeting by end-November. Nevertheless, we urge the authorities to proceed according to the envisaged timetable, in order to translate the

ERSWEC into a full fledged PRSP in the coming months, after a proper consultative process.

With respect to the focus of the ERS, it is appropriate that governance issues are placed at the top of the policy agenda, as highlighted by Mr. Usman, since those issues are hampering not only a sustained economic development drive, but also credibility in policy actions, while they have also been part of the unfulfilled conditionality of the previous arrangement with the Fund. Restructuring public finances, reforming the financial sector and SOEs, and introducing greater flexibility in the labor market and trade regime, are valid and necessary additional axis to the authorities' plans. However, as the staff has indicated, we consider it essential that the authorities clearly identify a limited set of key actions to carry out their growth enhancing and poverty reducing strategy, given the limited resources and capacity constraints. Completing an up-to-date poverty assessment should significantly help them in identifying and prioritizing target groups, as well as on achieving an adequate follow up and appraisal of the efficiency in the implementation of their strategies. Such line of action is called for since most social indicators have deteriorated over the past decade. As to the expected macroeconomic outcomes in the medium term, we wonder if they are excessively optimistic since performance under the past program was dismal across the board. Perhaps alternative scenarios should be included. The staff's comments are welcome.

On fiscal issues, strong reforms are required on all fronts: revenue, expenditure, and financing. On the revenue side, a good starting building block is the strengthening of the tax administration agencies, not least by means of mergers and development of information technology systems. The immediate aim of those actions should be to broaden the tax base by attempting to include informal transactions. Eliminating exemptions is highly critical in these efforts, since it facilitates the enforcement and monitoring role of the tax agencies. Nonetheless, the revenue collection gains in the medium term would come from three sources: VAT, import duties, and other revenue measures. While there is no specific detail as to what measures would allow for a 1.2 percent of GDP increase due to the latter, we would also like to ask the staff, how reliable are those estimated revenue gains, which albeit modest, will have to come in a context where import tariff rates are set to decrease and the VAT rate is also being lowered by 2 percent, as stated by Mr. Usman.

On the expenditure side, we welcome the authorities' acceptance of conditionality on public expenditure management, since it is an area in need of broad and urgent reform, along the recommendations of the recent technical assistance mission. Linking pro-poor spending to budget codes is an adequate measure in order to guarantee and facilitate monitoring of such expenditures. On a medium-term perspective, we welcome the intentions to marginally reduce recurrent spending, including the wage bill, and to substantially increase development spending and net lending, which are set to increase by 4 percent of GDP over the next five years. However, we wonder how realistic the latter might be, since it will require quadrupling domestically financed spending and could put into question implementation capacities. The staff's comments are welcome.

On financing, the authorities' aim of replacing short-term expensive domestic financing by external grants and concessional loans is well intended, but we advise them not to push it to extremes, to avoid adding further vulnerabilities to the program. In this sense, given the size of the financing gap bordering 5 percent of GDP per year since 2004, even after considering increased donor support, we wonder if this scenario is attainable and would not exert undue stress on the balance of payments. We urge the authorities to consider contingency plans, limiting expenditures growth, in case foreign support does not materialize in the desired magnitudes. Finally, on the projected path of the public debt, the staff's updated DSA is reassuring. Nevertheless, GDP growth below projections, combined with the envisaged widening fiscal deficits and unexpected delays in Paris Club rescheduling could very soon complicate the picture.

We welcome the authorities' strategy to deal with inflation by using reserve money targeting, with broad money as an intermediate target and open market operations as the main instruments. The recent spike in inflation and the accelerated rates of growth of some monetary aggregates in the past, call for unbending discipline in this front. It is important to note that the consistency of the monetary program relies in no small part in double digit and accelerating contractions in net credit to the government over subsequent years, in order to break with and revert the trend observed in the past years. In addition, close coordination of monetary and financial policies is crucial, given the fragile status of the banking system, which is in urgent need of reform, as indicated below. Continued strengthening of the Central Bank of Kenya (CBK), as signaled by the latest safeguards assessment, is also necessary. With regard to the exchange rate, the current flexible arrangement seems adequate and should be maintained.

Advancing with structural reforms is crucial to a successful implementation of the development strategy. On financial sector reforms, while more advise should be made available once the ongoing FSAP review is concluded, political criteria in the loan decision process should be eliminated, which requires divestiture in publicly owned financial institutions and stronger bank supervision. Also, as indicated by the staff, insolvency and creditor rights frameworks need to be upgraded and modernized. On trade liberalization, we agree on the positive effects of a phased reduction in the barriers to trade, including tariff rates and other distortions. Nevertheless, efforts to improve the economy's competitiveness also pass through maintaining a flexible exchange rate regime, increased flexibility in labor markets and improving infrastructure and services, mostly oriented to rural areas where agricultural activity is predominant. To this end, the focus on reforming the agricultural sector and encouraging SMEs, within a decentralization view, is called for, and should be detailed further in the PRSP. But once again, we warn against increased development spending at levels that could imply exacerbating external vulnerabilities due to financing constraints. Finally, it is important to promote private investment, both in new projects as well as through divestiture of public sector participation, once the rules of the privatization agenda are clearly established and transparent. A strong inflow of resources through the capital and financial accounts is an essential element considered in the program.

We wish the authorities every success in the multiple challenges lying ahead, not least their request for a Paris Club rescheduling and substantially increased donor support, critical elements of the proposed program.

Mr. Misra submitted the following statement:

Key Points

- We support the new 3-year PRGF arrangement with governance at the center of the development strategy. We hope that the authorities would manage the reform agenda effectively with liberal donor support.

- Box 1 makes an impressive list of reforms. We look forward tomatching actions for sustainable growth.

- Improving efficiency and establishing credibly functioning institutions of governance and popular support for reforms is very critical.

- The authorities have already initiated reform measures under ERS reflecting the priorities of PRSP and aligning the budget process accordingly. Explicit provision in the budget for contingent liabilities and increasing the local government capacity are welcome.

- The growth and poverty reduction strategy with focus on agriculture sector and containing inflation are appropriate, though the debt reduction strategy is ambitious and seems to be prone to uncertainties.

- We agree on the need for poverty assessment and support staff suggestion on the use of participatory process for the implementation of ERS and to undertake poverty and social impact analysis.

We thank the staff for providing an excellent set of papers and Mr. Usman for his helpful statement. The fiscal position is deteriorating, and dependence on external finance is becoming unavoidable. Most of the social indicators are depressing. The institutional and economic problems of Kenya are arising mostly from within, while some of the unfortunate non-economic exogenous shocks have further complicated the growth prospects. As such, we feel that the authorities, on the strength of some of the reform measures already initiated through Economic Recovery strategy for Wealth and Employment Creation (ERS) and guided by the reform agenda on hand, would be able to find sustainable solutions for increasing growth and reducing poverty. Further, the subdued macroeconomic performance coupled with the sharp increase in food prices has exposed most of the Kenyan people to adverse impact and are likely to dislocate government expenditure priorities. That being the case, Kenya needs liberal international support. Accordingly, we support the new three-year PRGF arrangement.

The two most important objectives, namely, sustainable debt management and increasing investment for growth would critically depend on the institutional strength and integrity. Since resurgence in economic growth is expected to be driven by increased public and private investments, a credible business-friendly environment is essential to sustain growth. Furthermore, insulating the reform agenda in Box 1 from suffering the consequence of the kind experienced in the implementation of prior actions by December 2002 due to factors associated with national elections, would require continued demonstrable ownership and public support. We urge the authorities not to allow any slippage in those initiatives as the outcome of the various reform measures particularly depend on the credibility of governance institutions.

The structural reform agenda carries an impressive list of initiatives to be completed in the first year. However, the test is in implementation that matches the listed intentions. The initiative for capacity building in the Kenyan Revenue Authority and the enactment of anti-corruption legislation are likely to have lagged impact and hence the sooner these measures are implemented the better it would be for sustainable outcomes. We are pleased to note from Mr. Usman's statement that some measures in this direction have already been taken. The list of actions taken and the planned actions as in Box 6 indicate scope for a very promising business environment. Having demonstrated their commitment, the authorities need to obtain increased popular support for these measures and avoid any slippages.

On the fiscal policy, the emphasis on revenue raising measures through simplified tax measures, removal of exemptions, and capturing informal transactions into the tax net are appropriate. Simultaneously, effective system to monitor expenditure has to be in place along with poverty tracking systems, reforms in procurement systems along with the development of Commitment Control System to minimize deviations. Therefore, we welcome the sound expenditure and budget management measures that are planned to be implemented. Such a mechanism would also help to review the program for midcourse corrections and help using the scare resources more prudently. We would like the staff to let us know if any of the present tax exemptions are directed at the poor, the removal of which would depress the conditions of the poor further.

The explicit provision in the budget for dealing with contingent liabilities is a prudent measure. We also support the strategy to raise spending by local authorities by strengthening budget management, expanding the local revenue base, and enhancing implementation capacity in the context of poverty reduction program. These measures, if sustained, are likely to reduce burden on national budget in the long run. In this context, we would like to know the time line for creating the necessary legal framework and an assessment of risks that the staff foresees in this direction. We welcome the setting up of a committee to evolve new mechanism on civil service wage settlement and encourage them to expedite the overall civil service reforms focusing on productivity and efficiency. We assume that the list of activities for quarterly monitoring in place until 2002/03 has been expanded after assessing the effectiveness of the system and its cost reduction potential. We welcome staff comments on the cost reduction potential.

We agree that promoting economic and employment growth through expansion of increased investment in infrastructure are appropriate in the context of poverty reduction and for expanding the sources of growth. The reforms in labor market, parastatal sector, strengthening financial system, reorienting the Central Bank of Kenya function towards market based economic policies, and elimination of domestic borrowing requirements by 2004/05 are the needed thrust areas. Associated efforts at fiscal consolidation and restructuring, building international reserves, and increasing export competitiveness are equally important.

The foundation being laid for fiscal consolidation and increasing international reserves seems to be very fragile in the absence of donor support or external financing. We are confident that the authorities would be able to obtain sustained donor support on the strength of program outcomes from the first year itself. Similarly, the dissipated price pressure, particularly in the context of food and fuel prices is very sensitive. With the majority of the population being poor, any increase in food prices is likely to erode popular support for the program. Therefore, the inflation objective of monetary policy and the intention to be on the guard through effective monitoring by CBK is appropriate.

We agree with the overall strategy of the PRSP as assessed jointly by the Bank and Fund staffs. It is disappointing that poverty assessment has not been carried out for some time. We agree with the staff on the need for such assessment and their suggestion on participatory implementation. We are encouraged to note that the authorities intend to make use of the international support to put in place a poverty tracking and program evaluation mechanism. We hope that the impact assessment result would be widely made use of by the authorities for meaningful review of the program from time to time.

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

Mr. Wang and Ms. Wu submitted the following statement:

At the outset, we thank the staff for a very interesting and well-balanced paper as well as the related background papers. We also thank Mr. Usman for his reassuring statement.

Kenya's economic growth is sluggish. Apart from inflation and the external current account position, performance under the last PRGF-supported program was unsatisfactory with real GDP growth averaging less than 1 percent, a widening overall fiscal deficit, and declining international reserves. Above all, poverty is widespread and donor assistance is on the decline.

Faced with these entangled problems, Kenya is definitely in need of external assistance to finance the gaps. However, this is not the reason why we support the proposed new PRGF arrangement—at least, not the major one. Our support is based on the faith we have in the authorities. Their broadly based Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC) aims to reduce poverty and promote strong economic and employment growth and outlines a reform agenda covering a wide-range of economic problems. This thoughtful ERSWEC will expand into the full PRSP and the authorities have made realistic plans to implement the strategy. We believe their strong commitment and the actions taken to tackle the deep-seated corruption and governance problems are proof of the importance they attach to carrying out structural reforms.

Nevertheless, the campaign to fight corruption is only a first step in implementing the far-reaching reforms. The daunting challenges ahead require a long-term commitment and continuous actions in almost every aspect of the economy. Among them, growth/poverty reduction and governance improvement are the most crucial issues to be addressed.

We appreciate the help given by the Bank and other partners in helping the authorities assess the poverty situation and its determinants. This is extremely necessary before taking any concrete steps in poverty reduction. The expansion of the poverty-related expenditure tracking system is also important to ensure that core poverty expenditures are fully embedded in the ERSWEC. The authorities are commended for completing the draft listing of pro-poor expenditures linking priority programs with the budget codes. We applaud the rise in the proportion of local authorities' spending to ensure implementation of the poverty reduction program. In addition to these measures in favor of the poor, we strongly support the idea of "expanding the opportunities available to the poor for productive employment" as the way to tackle poverty. Needless to say, resource allocation is crucial, but what is more important is to provide education, assistance in finding jobs and expanding the agricultural sector since most live in rural areas. Thus, we praise the authorities for moving in the right direction with. long-term rather than temporary, measures to help the poor. Moreover, infrastructure building, especially the health service, is also needed.

The poverty reduction and growth issue is inseparable from good governance. Only the latter can ensure that resources are channeled to the right areas. Thus, the initiatives being taken by the authorities are of great significance. The recently enacted Public Officer Ethics Act and the Anti-Corruption and Economic Crimes Act serve as a solid legislative framework and a good start to the anti-corruption fight. Reform of the primary governance institutions and the appointment of the new judges are well directed and focused.

Again, in addition to the authorities initial encouraging steps, they must continue their firm resolve to carry out their planned strategy in order to gain external support and, most importantly, to develop the economy and address the problems.

We would like to ask the staff two questions:

Is there any progress on the authorities' rescheduling discussions with the Paris Club?

Box 9 shows revenue losses associated with trade liberalization and an estimate of the implication on revenue losses by lowering the upper tariff band from 35 percent to 25 percent. Will this be compensated by other customs revenues? Are any measures being taken to expand the revenue base?

With these remarks, we wish the authorities all the best in tackling the problems and forging ahead.

Mr. Scholar and Mr. Williams submitted the following statement:

Key Points

- The Economic Recovery Strategy is a clear articulation of the authorities' broad objectives for improving economic performance and reducing poverty. The JSA provides useful suggestions for strengthening it further. However, in finalizing the ERS, the authorities should allow sufficient time to undertake a fully consultative approach. To ensure the success of the ERS, the authorities need to build a greater consensus for wide-ranging reform;

- We support the PRGF arrangement, noting the breadth and depth of prior actions undertaken by the authorities. The conditionality under future reviews should include greater coverage of governance, state-owned enterprises and the banking sector;

- Future review documents should include greater analysis of risks and provide alternative scenarios. We believe alternative scenarios will help build the case for reform and should be discussed and agreed with all interested stakeholders; and

- Future documentation should include more analysis on poverty, attainment of the MDGs and the distributional impact of policy options supported by the PRGF.

We welcome the discussion of a new three-year Poverty Reduction and Growth Facility (PRGF) for Kenya. Although it has taken longer than expected to present the new program to the Board, we believe that this extra time has provided the authorities with the necessary space to both take stock of the economic and social situation in Kenya and start the process of outlining their strategy for improving economic performance and reducing poverty.

Economic Recovery Strategy for Wealth and Employment Creation (ERS)

Although at a nascent stage, the authorities have in the Economic Recovery Strategy (ERS) articulated their own broad strategy for poverty reduction while, at the same time, building upon the strengths and overcoming the weaknesses of the previous I-PRSP. The Joint Staff Assessment (JSA) rightly acknowledges this but also makes a number of pertinent suggestions for improving the content and focus of the final strategy.

We agree with the JSA recommendations that the final ERS should include contingency financing plans and a firm commitment to reallocate resources both within and across sectors. This is particularly important as the current Investment Program is only partially funded within the current PRGF macroeconomic framework—around 20 percent of financing needs have been identified—and because ODA financing is usually subject to lags. The JSA also rightly stresses the importance of an effective Medium-Term Expenditure Framework (MTEF) process, with an integrated Public Expenditure Review (PER), for effectively re-allocating resources according to policy priorities and, in so doing, aligning the national budget process with the objectives of the ERS. We also believe that the authorities need to enhance their risk management capacities so that policies and budgets can be adapted in the face of exogenous shocks.

Given the need to finalize the Investment Program which underpins the strategy, address the many sensible recommendations by the JSA and maintain the wide-scale participatory process, we believe that the authorities' target date of December 2003 for finalization of the full ERS looks very ambitious. The quality of the final ERS should not be compromised by timetable considerations. It is clearly important that over the short- to medium-term all development partners—including the Fund—should continue to engage in the process and provide coordinated analysis, advice and support to the authorities.

Poverty Reduction and Growth Facility (PRGF)

We believe the document presents a good overview of recent developments in Kenya and support the decision to proceed with a new PRGF. In supporting the new arrangement we note the breadth and depth of prior actions which the authorities have undertaken, including those on improving governance, and believe these actions demonstrate their commitment to the reform agenda and the program.

The current scope of the PRGF is appropriate and we particularly support the emphasis on the need to tackle the inter-related issues of good governance, transparency, public financial management and accountability and public sector reform, including advocating mechanisms for addressing the burgeoning wage-bill; the commercialization and privatization of state-owned enterprises; and, reforms to the banking sector. Given that progress in these areas will be critical to improving Kenya's growth potential and to reduce poverty, we hope that subsequent reviews will include more conditionality relating to state-owned enterprises and banking and financial sector reforms (informed by a Financial Sector Assessment Program). Such a focus would be consistent with the direction given by Directors in concluding the 2003 Article IV consultation.

We appreciate the discussion of risks to the authorities' economic strategy and the PRGF in the program document. While we welcome the strong focus on the need for political commitment to see through the reform agenda, and think this is appropriate in the light of Kenya's very poor track record under previous arrangements, we believe that the program underplays other risks. In particular,

- the program makes some bold assumptions on the pace of implementation of the wide-ranging policy reforms in many different and domestically sensitive areas. We note that overly ambitious assumptions on the pace and sequencing of reforms was one of the reasons for non-completion of previous arrangements;

- given the potential for slippages in the structural reform agenda and adverse exogenous shocks, the assumptions on growth and revenue are possibly on the ambitious side. We would also like to highlight the ongoing negative impact of HIV/AIDS in Kenya, as noted by the recent WB Country Economic Memorandum;

- assumed program support for this fiscal year may prove to be optimistic given the delay in the presentation of the PRGF and the pace of implementation of fiscal and fiduciary reforms.

Consequently, we would recommend that future review documents include alternative scenarios—higher and lower cases. Lower case scenarios should be used as the basis for contingency planning. And, high case scenarios could help the authorities make a case for larger aid flows by demonstrating the link between larger external support and attainment of the Millennium Development Goals (MDGs). Such scenarios could also help the authorities make the case domestically for rapid policy reform based on a strong understanding of the alternative outcomes under less rapid reform. It would also be helpful if the external financing projections and assumed policy scenarios were more fully discussed and agreed with relevant stakeholders.

We are disappointed that the PRGF document includes relatively little discussion of poverty in Kenya and there is no reference to the likelihood of Kenya attaining the MDGs and what would be needed for it do so; this is a gap we would like to see addressed in future review documentation as well as the next Article IV. We would also like to see further reviews include a stronger link between policy recommendations and their impact on poverty reduction. In this regard, we would encourage staff to undertake and take note of distributional analysis of the impact of the key reforms the PRGF is supporting.

We commend the authorities for their commitment to greater trade liberalization through the reduction of external tariffs and to regional integration through the standardization of incentives and harmonization of investment codes within the East African Community (EAC) Customs Union. However, we believe that further trade liberalization measures should be informed by an analysis of the costs and benefits to the economy and the likely impact on poverty. We would therefore urge the Fund, in conjunction with the other members of the Customs Union, to undertake a regional poverty and social impact analysis (PSIA) on the effects of trade liberalization on poverty, revenue mobilization and competitiveness at the national and sub-regional level so as to provide the Customs Union members with informed policy choices before recommending any further policy changes. We understand that a number of bilateral development partners are also interested in these issues and would welcome the Fund's active engagement in this work.

We welcome the background paper on Kenya's debt position under various alternative rescheduling and debt reduction scenarios (SM/03/373). We note that the program assumes that Kenya will be asking the Paris Club for flow rescheduling on Houston terms but would be grateful for staff views as to whether they believe Kenya would be advised to seek Naples Terms.

Looking ahead, we note that the PRGF will be a key instrument for the implementation of the ERS; we hope therefore that the assumptions (including alternative scenarios), policy content, and conditionality of future reviews will fully reflect the priorities identified in the ERS and the national budget, will be subject to intensive discussion with all interested stakeholders and that mechanisms can be found to incorporate their comments in the review design and associated documentation.

We look forward to discussing the first review and wish the authorities every success in building the necessary political consensus to ensure full implementation of the ambitious reform agenda.

Mr. Daïri submitted the following statement:

We thank the staff for an excellent report and Mr. Usman for his informative statement. Against the backdrop of weak economic performance, driven by domestic policy shortcomings, a deterioration in the terms of trade, low donor assistance, and a depressed tourism sector, the government has made progress toward restoring macroeconomic and financial stability and implementing far-reaching reforms, notably in the fiscal and governance areas. The authorities' Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC) is appropriately geared to promoting growth and poverty reduction through strong adjustment and reform policies, underpinned by good governance, public sector efficiency, a strong financial sector, and a liberal and competitive trade and exchange regime. The authorities are resolved to restore credibility to their policies in order to attract the necessary external support and investment to foster their socio-economic agenda. We agree with the thrust of the staff appraisal and policy recommendations.

Fiscal consolidation is receiving deserved focus under the program as a vehicle for restoring debt sustainability and for supporting private sector-led growth and poverty reduction. Although the deficit is expected to widen in 2003/04, donor assistance will allow domestic borrowing to be reduced. Over the medium term, the government is expected to repay the large domestic debt, and the consequent lower interest payments will permit increased poverty-related spending. Correcting existing weaknesses in expenditure management is critical to sustained improvement in the fiscal position, and this is being given due attention. Appropriate mechanisms are being instituted in line with FAD recommendations to control expenditure at the commitment and payment levels to avoid reoccurrence of overruns and accumulation of arrears, and will be subject to close monitoring in the form of structural conditionality. Expenditure prioritization and reorientation toward social and economic sectors is essential. We welcome the emphasis on linking the budget to the medium-term expenditure framework (MTEF), reducing the wage bill, increasing appropriations for operations and maintenance, as well as explicit provisions for contingent liabilities in the budget.

Although revenue performance is rather high by regional standards, reforms in tax policy and administration are needed to reverse the recent decline and reduce dependence on aid. To this end, restructuring of the Kenya Revenue Authority (KRA) will be uppermost to make it more efficient, while strengthening the legal framework to enhance tax enforcement and compliance and restoring the integrity of tax administration. Other revenue-enhancing measures include broadening the tax base, reducing exemptions, and simplifying the tax system. This should also allow a reduction of some tax rates to levels prevailing in neighboring countries.

Prudent monetary policy has been instrumental in achieving low inflation. The monetary program appropriately seeks to foster financial stability and to contain underlying inflation, while supporting a modest recovery in the economy. With credit to government winding down, lending to the private sector will show a concurrent rise. Given potential variability in money demand arising from changing economic conditions, relying on a broad set of indicators in monitoring inflationary pressures and in determining the monetary policy stance is appropriate. It is noted that the monetary transmission mechanism is under review, while possible adoption of an inflation targeting framework is being considered. There is a need, however, to assess and mitigate the risks to bank profitability stemming from the low treasury bill rates; staff may wish to elaborate on potential avenues in this area. Kenya’s floating exchange rate regime, which the authorities are committed to maintain, remains appropriate for safeguarding external competitiveness and as a safety valve for exogenous shocks. While non-traditional exports have shown strong growth over the past three years, close monitoring of the exchange rate is important in light of recent appreciation.

Structural reforms will be instrumental in strengthening the economy's competitiveness in order to spur growth, employment creation, and enhanced social indicators. In this regard, reinforced public enterprise restructuring and privatization are key to strengthening economic efficiency and to fostering fiscal sustainability. The authorities have indicated a strong commitment to a transparent privatization process; they are encouraged to follow through with the bill to establish the requisite framework. They also realize the importance of a liberal trade regime in promoting the economy's competitiveness and efficiency and in improving growth performance. Trade reforms will seek to lower external tariff rates and reduce the bands, consistent with the agreement of the East-African Community (EAC) customs union, streamline the customs clearing system, and address weaknesses in the export incentive system. Enhancing the attractiveness of Kenya as an investment destination calls for a competitive cost structure, and planned reforms of the labor market, the utilities sector, the road and transport sector, and port services are important initiatives in this direction.

Financial sector reform is receiving the necessary attention to address the wide-ranging fragilities cataloged in Box 7 of the staff report and to improve financial intermediation. Measures related to the transfer from the Ministry of Finance to the Central Bank of Kenya (CBK) of full power of licensing, delicensing, regulation and supervision of banks are noteworthy. Particular attention is also required in bank recapitalization and privatization as necessary, while strengthening supervision by enforcing prudential requirements. The legal framework also needs to be reformed, particularly in insolvency and protection of creditor rights as well as in increasing flexibility in bank operations, including in setting credit and interest rate terms, and we look forward to revisions to the Banking and CBK Acts in this regard. The program of actions elaborated in Box 8 is appropriately directed to addressing the problems in the financial system, and we urge their expedited implementation. The ongoing FSAP will make further contribution to promoting financial sector stability. The CBK has made significant progress in improving its safeguards and the authorities intend to address remaining vulnerabilities especially in respect of monetary and financial data reporting.

To allay past concerns, and in the pursuit of efforts to regain donor support as well as public and investor confidence, the authorities have placed governance at the top of their agenda. It is reassuring to learn from Mr. Usman's statement that the authorities have implemented all the governance measures included in the previous arrangement in addition to all prior actions in the areas identified in the last Article IV staff report. The range of actions already taken or contemplated in this regard is elaborated in Box 6 of the staff report and paragraph 11 of the MEFP, and attests to the authorities' resolve to address the problem forcefully. It is important, however, to prioritize actions in this area in view of the limited capacity and the need to reduce costs and deliver desired results with efficiency, thereby gaining public trust and confidence.

The medium-term economic prospects represent a significant improvement compared with past performance, with growth expected to increase steadily—buttressed by rising savings and investment—within a low inflation environment. The external current account deficit will, however, increase to accommodate higher inflows of external assistance in support of the economic expansion. Significantly, Kenya's debt ratios remain below HIPC thresholds, while the debt dynamics are expected to follow a favorable trend, assuming that a strong stance of policies and reforms remains in place. Long-term debt sustainability prospects will be enhanced under the authorities' plan to eliminate domestic borrowing and shift to grants and concessional loan financing, while negotiating rescheduling agreements with bilateral creditors. We support the authorities' intention to seek concessional debt rescheduling from the Paris Club. Other planned debt management measures enumerated in Box 5 are well directed to easing Kenya's debt problem. Prudent debt management is particularly important as staff analysis—based on even less stringent scenarios—appears to indicate high sensitivity of the debt dynamics to an uncertain macroeconomic environment.

Drawing on the draft PRSP, the Economic Recovery Strategy (ERS) embodies a program to alleviate poverty through growth, employment creation, rural development, and increased spending on the social sectors. The initiative to expand the set of "core poverty programs," to be monitored under the strategy, is welcome. Measures aimed at promoting small- and medium-sized enterprises and micro-finances addressing HIV/AIDS, and expanding the role of local government will be key to the success of the poverty-reduction strategy, especially in the rural areas. The authorities are encouraged to consider staff recommendations in improving the quality of the ERS. Particularly important in this regard are: identification of a limited set of priority actions with the greatest impact on growth and poverty reduction, poverty and social impact analysis of major structural reforms, updated and deeper poverty diagnosis, and effective alignment of the budget and the ERS. We support staff recommendation, based on the satisfactory progress on the development of the ERS, for continued access to Fund concessional assistance and IDA assistance.

The authorities will be challenged in overcoming internal political tensions and in building consensus for their policies. Steadfast implementation of their program will be the strongest mitigating response to a potential adverse external environment that staff allude to. The authorities' program is of adequate strength and quality to deliver their objectives of high growth and poverty alleviation. They have demonstrated a strong commitment to its forceful implementation, including by taking all prior actions. We can, therefore, support approval of the PRGF arrangement as well as Mr. Usman's call for maximum financial and technical assistance from the international community.

Mr. Yagi and Mr. Naka submitted the following statement:

Kenya is a typical example of a country whose economy was blessed with diversified structure and the ability to acquire foreign exchange through key industries, but whose growth has been hampered by poor governance. The fact that not a single review was completed after the previous two arrangements started is attributable to the lack of governance, in particular civil service corruption and limited capacity in fiscal management. On this occasion of the request for a new arrangement under the Poverty Reduction and Growth Facility (PRGF), the most important issue is whether the authorities have learnt lessons from their past failures and whether they can restore the Fund's and other donors' confidence in them by introducing measures to prevent a similar failure and demonstrating a renewed commitment to reform. In this regard, we welcome the fact that the authorities recognize that pervasive corruption has seriously undermined economic performance and the foreign direct investment climate, and that they have launched a number of anticorruption measures.

In order to achieve sustainable growth, in addition to improve governance, there are many measures which require decisive implementation such as financial sector reform centering on the disposal of nonperforming loans (NPLs), the restructuring and privatization of the parastatal companies in a transparent manner, poverty reduction, and the establishment of basic infrastructure for maintaining competitiveness. In this regard, the Economic Recovery Strategy, which the new government developed as part of their medium-term reform strategy, is a sign of their renewed commitment.

However, the medium-term projections shows that large financing gaps need to be filled in order to bring the economy back on to a sustainable growth path, even if some growth could be achieved by means of the above reforms. In this regard, the restoration of external assistance is critical.

Against this backdrop, a new arrangement under the PRGF would be expected to underpin the authorities' reform momentum, contribute to economic stability and growth, and encourage a resumption of donor assistance and foreign direct investment. We therefore support the request for such an arrangement. However, we would like to reiterate that, in light of Kenya's past disappointing track record, implementation of the reforms, in particular on governance which requires strong political commitment, is likely to confront various difficulties. In addition, the authorities should recognize that commencement of the program is only the first step toward confidence-building and that a complete restoration of confidence depends on the steady implementation of the policy measures in the program.

Since we agree with the thrust of the staff appraisal, we will focus our comments on a few areas for emphasis.

Governance

The authorities' decision to place improvement of governance, in particular the fight against corruption, at the center of their reform strategy is appropriate given the country's dominant public sector. We expect the authorities to implement the core reform measures decisively, in particular by strictly enforcing the Anti-Corruption and Economic Crimes Bill, the Public Officer Ethics Act, judicial reform, and reform of the procurement system.

It is also imperative to improve the authorities' fiscal management capacity, which has also hampered effective implementation of policy measures. Given that fiscal policy is the key foundation for growth, the authorities should take decisive actions to improve such capacity. In particular, it is essential to improve the expenditure-tracking system to ensure that budget-resources are adequately allocated for priority areas such as poverty reduction, education, health, and the building of basic infrastructure.

Fiscal Policy

Kenya's fiscal position remains fragile. While the two goals of fiscal policy, namely to restore debt sustainability and to increase investment conducive to growth, might well encounter difficulties, we are encouraged by the staff's view that the repayment of domestic debt and expected inflows of grants and concessional external finance should enable the authorities to achieve both goals. That said, increased reliance on donor assistance would increase Kenya's vulnerability, and thus the authorities need to implement policy measures on both the expenditure and the revenue side.

On the revenue side, the authorities need to rationalize the inefficient and complex tax structure which is hampering economic activity, and to strengthen tax collection. In this connection, we consider the authorities' intention to simplify the tax structure, broaden the tax base, rationalize exemptions, and strengthen tax administration appropriate. Regarding expenditure, efficient resource allocation to priority areas such as poverty reduction and economic growth is critical. It is also important to ensure consistency between the annual budget and the medium-term expenditure framework, as well as to improve the expenditure management system. At the same time, the authorities should give due consideration to containing nonpriority expenditures. We urge the authorities to implement decisively the reform of the procurement system which encouraged corruption, and to reduce the wage bill as a part of the civil service reform.

Structural Reforms and Improving Competitiveness

Sustainable growth cannot be realized in the absence of an active private sector. Reform of thee inefficient public sector, especially public enterprises, is key to enhancing the vitality of Kenya's economy. While we welcome the authorities' decision to accelerate privatization, much needs to be done to address impediments in the divestiture process which among other things, bring about the stagnant sale value of enterprises. Like the staff, we urge the authorities to consider engaging professionals to generate strong investor interest and to maximize realized values, as well as to increase the transparency of the process.

Meanwhile, from the standpoint of maintaining international competitiveness, improvements in the business climate, such as enhancement of the basic infrastructure, including roads; simplification of the tariffs schedule; and a speedup of customs clearance, should contribute to export sector development and promote foreign direct investment inflows.

Monetary Policy and the Financial Sector

While we welcome the authorities' flexible exchange rate policy, we agree with the staff's suggestion that they should be vigilant against exchange rate fluctuations in order to maintain international competitiveness. In addition, monetary policy should aim at striking an appropriate balance between dealing with excess liquidity and ensuring soundness of the banking system. Furthermore, in order to help revitalize private sector activity, the fragile financial sector must be restored and financial intermediation strengthened. To this end, we strongly urge the authorities to promptly dispose of existing NPLs and contain the generation of new NPLs, to withdraw from bank management, and to strengthen the supervisory function of the Central Bank of Kenya (CBK). In view of the expected increase in capital inflows as reform gains pace and the need to contain inflation, the CBK's role will become increasingly important. We hope that the ongoing Financial Sector Assessment Program will contribute to helping the authorities develop strategies for addressing the issues mentioned above.

Debt Sustainability Analysis (DSA)

The staff's DSA analysis suggests that debt sustainability can only be achieved by substituting domestic debt with increased inflows of external grants and concessional loans, as well as external debt rescheduling. Given such prospects, it is crucial for the authorities to demonstrate a strong renewed commitment to pursue various reforms and to build confidence through steady implementation of the program. We look forward to the authorities' strong efforts toward program implementation.

With these remarks, we wish the authorities every success.

Mr. Bennett submitted the following statement:

Key Points

- We support the proposed PRGF. It appropriately focuses on governance.

- The combined IMF/World Bank conditionality seems quite streamlined given Kenya's history, and we agree with Mr. Scholar and Mr. Williams that consideration should be given to include more conditionality relating to state-owned enterprises and banking and financial sector reforms.

- The JSA gives the impression that the Fund staff is reluctant to support poverty and social impact analysis. We think more resources should be made available for the staff to undertake PSIA.

- After having heard Jeffrey Sachs last week, I could not help but notice how little attention the MDGs received in the documents. We hope that the MDGs will be incorporated into the full PRSP, as well future PRGF reports.

- While the staff report is well-written and quite comprehensive, I was disappointed that the request of the PRGF documentation did not provide an in-depth assessment of ownership—something we had requested in our last statement on Kenya.

We support the proposed PRGF arrangement. It appropriately has a major focus on governance, but also includes ambitious plans to eliminate domestic borrowing, improve public expenditure management, address weaknesses in the financial system, and implement comprehensive trade reforms. The combined IMF/World Bank conditionality seems quite streamlined given Kenya's history, and we agree with Mr. Scholar and Mr. Williams that consideration should be given to include more conditionality relating to state-owned enterprises and banking and financial sector reforms.

The linchpin of the program is, of course, governance. Without a significant improvement in governance, the growth targets, which are well above the historical trend, will not be achieved. Moreover, the program relies heavily on a major influx of donor support—and this will definitely not come to fruition if there is a sense that the government is losing its resolve. To the government's credit, it seems to be following through on its election commitments to address corruption, and deserves to be commended. The ultimate test, however, comes when governments have to confront corruption of one of their own party.

On fiscal restructuring, we agree with the staff that the large domestic debt will have to be reduced. The plans to rebuild the credibility and capacity of the Kenya Revenue Authorities are particularly welcome. Are statistics available to monitor tax compliance? Simple tax efficiency measures—as used for other country programs—could provide an indication as to whether the extensive reforms are providing tangible results.

Containing public sector wages will be a critical element to achieving fiscal targets, and given the uncertainties surrounding the negotiation process, the wage bill will remain a bit of a wild card going forward. An update by the staff on wage negotiations, and an elaboration of the revised modalities for setting public wages (as suggested by Mr. Callaghan), as well as the staff's reaction to the work permit "crackdown" on expatriates would, therefore, be very helpful.

On monetary policy, the staff is rightly concerned about the authorities' actions and in-actions. Flooding the system with excess liquidity—in a creditor unfriendly environment with already large NPLs and poor governance—is unlikely to encourage productive lending, and carries major risks of widespread bank failures. We urge the authorities to move quickly to sterilize the excess reserves by end-December 2003.

On trade, we agree that the restrictiveness of the regime needs to be reduced. Equally important, however, is the need to reduce complexity and address the weaknesses in customs administration and corruption. We would appreciate it if the next report could provide an update and additional details on what best practices are being adopted by Kenya to improve the efficiency and integrity of the customs administration system.

On the Joint Staff Assessment of the PRSP, we support the useful recommendations made by the staff. However, I was struck by how unenthusiastic the wording was on undertaking poverty and social impact analysis ("The staff also encourages the government to mention in the ERS plans to undertake PSIA"). Moreover, the JSA does give the impression that the Fund is reluctant to support PSIA (the report notes that "the Bank would be prepared to support the government with any analysis", but does not mention the Fund). As we had said during the Board meeting on Sudan, the MD made a clear commitment to African Finance Ministers at the Big Table session that he would be encouraging the staff to undertake PSIA. We hope sufficient resources can be freed to up to allow staff to do this.

After having heard Jeffrey Sachs' plea last week that the Fund should put an increased focus on the Millennium Development Goals, I could not help but notice how little attention the MDGs received in the documents for this meeting, particularly given the sad state of social conditions in Kenya. We hope that the MDGs will be incorporated into the full PRSP, as well as future PRGF reports, as suggested in the U.K. statement.

Let me finish by making a couple of comments on the staff report. I think that, overall, the reports are very well written and quite comprehensive. However, I have to express my disappointment (as I have for other countries) that the PRGF documentation did not provide an in-depth assessment of ownership—something we had requested in our last statement on Kenya. In our view, it would have been useful to get information on important aspects of ownership, such as to what extent the rifts within the National Rainbow Coalition may prevent reforms, whether courts and Constitution will be an impediment to up coming reforms, and how much resistance can be expected on wage negotiations.

Mr. Ondo Mañe submitted the following statement:

We thank the staff for the comprehensive and well-written set of papers on Kenya as well as Mr. Usman for his insightful statement. Kenya has made valuable progress towards achieving sound macroeconomic foundations in difficult circumstances following the international travel advisory for this country with an important tourism sector.

It is encouraging to note the awareness and commitment of the authorities in tackling the major challenges that the Kenyan economy faces presently and in the period ahead. Prior to a full PRSP, they have designed a comprehensive development strategy, the Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC), which needs support from sustained and predictable financial assistance. Already, the authorities have successfully implemented the prior actions. We concur with staff's assessment that the program outlined in the MEFP is strong and credible and, thus, support the authorities' request for a new three-year PRGF arrangement.

The staff report clearly describes the stakes of a new three-year Fund-supported program, namely the success of forceful economic and structural reforms intended to get the Kenyan economy out of its current slump, pave the road towards debt sustainability, and establish sound and efficient financial intermediation. The proposed Fund-supported program would also generate donor assistance and, looking forward, could constitute a phase in a well-sequenced cooperation between low-income member countries and the Fund, in which a visible, predictable and non-permanent assistance is desirable.

While Kenya's performance under the last PRGF arrangement was mixed, one must nevertheless commend the authorities for subsequently meeting the objectives of that program. They should also be encouraged for making poverty reduction the utmost objective of the country's medium-term macroeconomic framework, with a pro-poor approach embodied in the ERSWEC. However, the medium-term external financial needs projected for the period ahead, coupled with the foreign reserves target, call for the assistance of the international community. As we broadly agree with the staff's analysis, we will comment on a few points for emphasis. Specifically, we will stress the strengths of Kenya's development strategy and highlight the program risks and challenges that the authorities are encouraged to address so as to achieve the smooth realization of their objectives, particularly those related to poverty reduction.

As regards fiscal policy, we commend the authorities for a thorough strategy aimed at fiscal consolidation through explicit budget provisions for contingent liabilities. Prioritization of public spending and the strengthening of public expenditure management, including the tracking of expenditures in a series of envisaged measures described in Boxes 4 and 5, are in the right direction. On the revenue front, it is encouraging to note the authorities' reform approach aimed at broadening the tax base while reducing tax administration inefficiencies through organizational changes and capacity building.

Fiscal consolidation will contribute to restoring debt sustainability. As regards the latter, we greatly appreciate the insightful analysis of staff reported in the DSA and summarized in Box 3 of the main paper. The finding that Kenya's debt dynamics are sensitive to the macroeconomic environment influenced by exogenous factors, calls for cushioning the economy against certain shocks. Clearly, actions that are needed include close monitoring of exchange rate movements while ensuring flexibility to absorb imbalances; removals of the burdensome customs procedures for exports; the fight against corruption within the customs administration; fiscal consolidation; and measures aimed at attracting more FDI as a substitute to debt-creating flows. We encourage the authorities to consider these actions, along with measures underway as regards tariffs (Box 9 of staff report).

Debt management should be another leverage to debt sustainability. Simulations depicted in Figures 2 and 3 of the DSA prompt us to encourage the authorities to engage in highly concessional external borrowing in place of rescheduling on non-concessional terms, as the latter would barely benefit the external debt situation as well as the debt service burden.

We are of the view that the Central Bank of Kenya's (CBK) monetary policy stance is appropriate and should continue to aim at containing inflation. However, care should also be given to mopping the excess liquidity which, coupled with low interest rates, could put pressures on the balance of payments. Likewise, we urge the authorities to tackle the NPL problem facing the banking sector and, more broadly, to address "cronyism", weak regulatory and supervisory frameworks, the lack of enforcement of creditor rights, and governance problems that adversely affect the financial sector. In this context, the findings and recommendations of the ongoing FSAP are most welcome.

Besides the financial sector, structural reforms in the areas of governance and tax administration are necessary. In this regard, we broadly agree with the staff's recommendations to the authorities. However, as regards the civil service reform, while we concur with the view that it is important to address the forces that have led to wage bill pressures, we would also like to caution against an expeditious process, as the pace and extent of reforms in this area may carry weight for political and social stability.

In conclusion, we strongly support the proposed decision for a three-year program under a PRGF arrangement, as Kenya needs financial and technical support from the international community in tackling the development and poverty challenges that it faces. We wish the authorities success in their endeavors.

Ms. Lundsager and Mr. Dohlman submitted the following statement:

Overview

The proposed three-year program covers an ambitious agenda with many measures oriented towards fostering the development of the private sector. We welcome in particular Mr. Usman's emphasis on the private sector as the source of growth. Steadfast implementation should help rebuild donor confidence and pave the way for additional resources from the international community. The proposed PRGF rightly places good governance, restructuring public finances, and key structural reforms at the center of the authorities' efforts to accelerate private sector-led growth and poverty reduction. We commend the new authorities for initial progress already made this year in the governance area, particularly the enactment of two key anti-corruption bills in May and steps taken to strengthen the judiciary.

Fiscal Policy

On the fiscal side, the recent sharp rise in domestic debt underscores the need for a stronger fiscal stance. The authorities have laid out ambitious plans for a major overhaul of the tax system and expenditure management and priorities. In the near-term, we welcome steps to rationalize wage setting (a more rapid reduction in the wage bill is a top priority), along with measures to control and monitor public expenditure. Other significant measures include plans to address contingent liabilities and other contingent risks, as well as clearance of pending bills. That said, we would have preferred to see some of the key fiscal (and other) reforms laid out in Box 1, such as expenditure reforms, initiated earlier in the three year cycle. Messrs. Scholar and Williams made a related point on the need for greater conditionality (which we share).

The authorities plan to increase spending on priority sectors, but much of this increase relies on additional donor flows. Some contingency expenditure cutting measures should be developed to ensure that priority spending in fact remains the first priority, rather than being the first item cut, in the event flows do not meet expectations.

Structural Reforms

Privatization: Plans for moving ahead with privatization of the telecom, banking and energy sectors are important both for fiscal sustainability and for reducing costs of doing business (a major impediment to growth and investment). We hope that efforts to put a strong legal framework and transparent process in place before privatization will be completed with an appropriate sense of urgency—this ties back into Messrs. Scholar and Williams' conditionality point.

Anti-Corruption Efforts: We strongly support the governance initiatives outlined in the program, such as the establishment of the Kenya Anti-Corruption Commission. Initial steps taken to enforce the Public Officers Ethics bill, which requires officials to declare their wealth, and to remove corrupt judges and other public officials are a good signal of the changing environment. We look forward to the continued effective implementation of this bill. To make significant inroads against corruption, however, we need fully functioning and effective institutions in place (preferably by the first PRGF review) that can provide sustained implementation of the anti-corruption strategy. On this note, we have concerns about the effectiveness of the Anti-Corruption Commission if it is not also given the authority to prosecute cases.

Financial Sector Reforms: The FSAP now underway will be an important step in strengthening the weak banking sector and reinvigorating financial intermediation—a key ingredient for promoting private sector-led growth. This sector remains a serious concern and a potentially significant drain on resources, with non-performing loans (NPLs) at nearly 30 percent of total loans. Since more than half of NPLs are held by public sector banks, we urge the authorities to articulate a clear schedule for moving ahead with addressing NPLs and proceeding with divestment. Legislative amendments to strengthen banking supervision, the regulatory system, and strengthen insolvency and creditor rights frameworks, as well as plans to improve credit risk assessment procedures for banks will help further boost the financial sector. We also attach great importance to transferring all regulatory responsibility to the Central Bank of Kenya and urge the authorities to overcome bottlenecks and capacity constraint in drafting legislation in order to submit the relevant legislation before March 2004.

We urge the authorities to implement the remaining recommendations of the safeguards assessment, and also urge further action on AML/CTF, taking into account the forthcoming FSAP results in this area.

Trade Reform: The authorities are taking long-overdue steps to rationalize their tariff schedule and to strengthen the customs division. The expected increases in revenues suggest further room for tariff reductions—which would further reduce private sector costs—in the context of comprehensive tax reform.

External

The DSA indicates that Kenya's external debt is sustainable (though sensitive to donor inflows). We note that expected increases in imports and a significant build up of foreign exchange reserves, particularly in the third year of the program, drive the need for exceptional financing in the form of a Paris Club debt rescheduling. The authorities will have to seek comparable treatment from private-sector creditors as well. We strongly agree with the staff that the prospective Paris Club rescheduling can be viewed as an "exit" treatment from the Paris Club. However, we have some concerns about the adequacy of medium-term adjustment, as the Fund's projections show the BOP gap continuing to rise after the end of the program, reaching $800m in 2008. More thought needs to be given over the course of the program to ensure that the authorities can meet their goal of an exit program.

Monetary and Exchange Rate Policy

We welcome the authorities' commitment to sterilize higher than anticipated reserve money, to refrain from imposing interest rate controls (a continuous performance criterion), and to maintain a floating exchange rate.

Other

ERS/PRSP: The authorities have engaged in a broadly participatory process in their preparation of the new Economic Recovery Strategy. We encourage the authorities to continue this inclusive process—including the private sector—as the ERS moves from formulation to implementation. Plans to encourage small and medium enterprise activity and to reform the agricultural sector should likewise reflect strong private sector input. The authorities have appropriately identified corruption as "a major cause of poverty" in Kenya, and have placed the fight against corruption and improved governance at "the center" of public policy. The recent completion of the PER provides important findings and recommendations for improving the budget process. We agree that enhanced public expenditure management is a critical link to implementing the PRSP. We look forward to completion of the full ERS, but consider the December 2003 deadline to be rather ambitious. Perhaps some additional weeks or months should be used to finalize this important poverty reduction framework.

Finally, we welcome the authorities' consent to publish the staff report.

Mr. Daïri questioned the appropriateness of including in the staff paper a reference to an exit strategy from the PRGF-supported program, given that Kenya was still a poor country and would need concessional resources, including from the Fund, for a long period of time.

Ms. Lundsager asked the staff whether an ex post assessment of Kenya's previous Fund-supported programs would be carried out. On the exit strategy, it seemed that the Kenyan authorities themselves were looking to move beyond relying on support from the Paris Club and the Fund and to develop a thriving economy with a growing, job-creating private sector. The Board should be supportive of that goal and help the authorities achieve it.

Mr. Williams agreed with Mr. Daïri that it was too early to discuss an exit strategy since Kenya had failed to complete its previous two programs. Although the authorities desired an exit strategy, the Fund should not prematurely push them to exit from the use of concessional Fund resources. The discipline imposed by a Fund-supported program would be helpful to the Kenyan authorities in the implementation of their structural reforms.

The staff representative from the African Department (Mr. Kalinga) replied that, on the question of the exit strategy, the authorities had indicated to the staff from the beginning of the discussions that they intended to complete the current PRGF arrangement and subsequently graduate to other arrangements that would not involve the use of Fund resources. Therefore, the reference to the exit strategy in the staff report reflected the wish of the authorities.

On the question of an ex post assessment, the conditions for a new arrangement with the Fund were laid out by the Board at the Article IV consultation discussion held in March 2002, the staff representative continued. At that time, the Board had clearly spelt out five conditions that would need to be met by Kenya before a new arrangement with the Fund could be agreed upon.

The staff representative from the Policy Development and Review Department (Mr. Fetherston) added that the Board had decided in April 2002 that as a transitional measure for members already engaged in discussions toward a new multi-year arrangement, the ex post assessment would be conducted at the end of the next arrangement. In the case of Kenya, preliminary discussions with the authorities on the current arrangement had begun in February 2003, which was before the Board's discussion on ex post assessments.

The staff representative from the African Department (Mr. Kalinga), in response to questions and comments by Directors, made the following statement:

> A question was asked about the staff's optimistic macroeconomic projections for the medium term. Directors will recall that, at the last Article IV consultation discussion, the staff had presented three scenarios—upper, medium, and lower. These projections are based on the median of those three scenarios. The experience that the staff has had in other economies, such as Uganda, Tanzania, and Mozambique, is that after a prolonged period of low economic activity during the initial 3-5 years, there is a significant spurt in activity. The question is not so much whether in the three forthcoming years an average growth of around 3 percent is achievable—that is very likely; the question is whether such a growth rate can be sustained beyond five years.
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> A question was also asked about the new wage-setting mechanism, particularly given that wages and salaries may rise. This issue has formed the basis of discussions both in February and May. Key to the problem is the fact that there was a wage agreement with the teachers in 1997, which promised them a salary increase of 7-10 percent per year for the next five years. The staff has demonstrated to the government that, if that increase is given to the teachers, then corresponding increases would have to be given to the rest of the civil service, otherwise salary differences between the teachers and the other civil servants would be too large. The idea behind setting up a committee to advise on a new mechanism for determining the wages of civil servants was for the government to re-establish a transparent process for public sector wage negotiations that is expected to take into considerations a variety of factors, including productivity growth, to ensure that wages are in line with the available resources and the objectives of the PRSP. The new mechanism is expected to ensure that ad hoc wage adjustments that threaten the viability of the budget, such as the 1997 teachers' wage award, are avoided. The committee is still working on its findings. A staff visit scheduled to begin on November 30 will be reviewing the findings with the government ahead of the February review mission.
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> On the reliability of revenue projections for 2003/04, the bulk of the increase in revenue projected for 2003—about 0.8 percentage point of GDP out of the projected 1.2 percentage points—is expected to come essentially from a rechanneling of resources that were hitherto channeled off-budget. These were revenue items that in the previous government had been used to fund operations outside of the government. These are realizable revenues, and more than 50 percent of them have already been collected.
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> A question was asked on the realism of the assumed increase in development expenditure of 4 percentage points of GDP over the next three years. One percentage point of that is accounted for by spending on education, much of which has already been implemented since early 2003. Directors will

realize that, in Africa, one mile of road costs about $1 million to build, so the spending on road construction is taking up a good proportion of the increase in development expenditure, together with health spending. For most of the subregion, but especially for Kenya, the capacity in building and construction is large; in fact, Kenya is a supplier of capacity to neighboring countries. Moreover, industries in Kenya operate with a 33 percent excess capacity, and in our discussions with the private sector, we have no doubt in the near term that the intended increase in development spending can be achieved without a significant increase in prices.

On whether any of the tax exemptions are geared toward the poor, the answer is yes. But it is not the authorities' intention to add to the tax burden of the poor. Most of the exemptions at this stage pertain to enterprises that are already enjoying considerable benefits from other components of the tax structure, and they would be implemented in the context of a general lowering of the overall tax burden.

On the timeline for implementing the decentralization system, it is not possible to give an estimate at the moment. The reason is that the decentralization process is a key issue that the Constitution Review Commission is looking at. It is just about to complete its work, but the outstanding issue is the decentralization process. Therefore, it is only possible to give a timeline after the Constitution Review process has defined the form that the decentralization will take.

A question was asked on the cost reduction potential of the new mechanism for setting civil service wages. As earlier indicated, the Committee has not yet released its results, and the preliminary results will be the subject of discussion with the December staff mission.

On whether there are adequate statistics to monitor tax compliance, in the *Selected Issues* paper for the last Article IV consultation the staff had presented a few indications on tax compliance rates for some industries. Broad ratios can be computed from available data, but the information base is being refined.

On the crackdown on expatriates, the staff has read this morning the statement that was presented yesterday at a meeting on promoting investments. Our view is that the statement does not make sense in terms of the overall thrust of the Economic Recovery Strategy. We believe that this is an area that could usefully be taken up by other donor agencies at the forthcoming CG meeting, in addition to the work that we will be doing. The CG meeting is the most appropriate forum to address this issue, as civil society, the president and his cabinet, and parliamentarians will be holding discussions with the donor community.

On debt, a question was asked whether there has been any progress made on a rescheduling framework. The Paris Club has indicated to the authorities that it is willing to provide financing assurances. The staff's understanding is that the Paris Club will be inviting the authorities in either December or January to discuss a rescheduling of its debt.

On the question of whether the authorities should seek Naples terms from the Paris Club, this is normally the subject of discussions between the authorities and the Paris Club creditors. The information that underpins the staff report provides scenarios for a rescheduling under Naples terms and under no concessionality. However, it is clear that Kenya is an IDA-eligible country and, as the debt sustainability indicates, the Naples terms would initially provide greater resources to enable the authorities to begin to implement their poverty reduction program, and would be a more suitable exit strategy from a rescheduling. However, the form of the negotiation would depend upon the agreement between the authorities and the Paris Club. The amount of debt relief that would be provided over the three years under Naples and Houston terms is very similar.

On the potential avenues to assess and mitigate the risks to bank profitability stemming from low treasury bill rates, the issue is under consideration in the context of the FSAP and future program reviews. The staff's view at the moment is that the current monetary policy stance and low interest rates are unsustainable. Comparing Kenya's country risk with comparable countries, it is clear that 1 percent is unsustainable and hazardous. In other comparable countries, the levels are around 7-8 percent. We have pointed out this issue to the Minister recently and will be following up with him in December.

On trade, a question was asked whether the revenue losses associated with trade liberalization will be compensated for. The present date for implementing the new lower tariffs is July 1, 2004, so the revenue for 2003 will not be affected. However, in the context of the program discussions, we are taking up steps, in consultation with the Fiscal Affairs Department staff, to identify new measures to offset any potential revenue losses. Present indications are that the losses would be around 0.2 percentage point of GDP, which we believe are addressable within the first year of the program.

Mr. Daïri said that, on the issue of treasury bill rates, care should be taken by the staff when delineating between fiscal policy and monetary policy. There was also inadequate discussion in the staff report on the feasibility of the authorities' request for an exit strategy.

The Acting Chair (Ms. Krueger) responded that taking into account the need for an exit strategy implied looking at debt sustainability levels and at the position of the country at the end of the Fund-supported program, more than saying exactly what would be implemented during the period of the program, especially given all the uncertainties involved.

The staff representative from the African Department (Mr. Kalinga) stated that, on the issue of the treasury bill rates, the authorities have a number of instruments for conducting monetary policy, but the principal ones had been treasury bills and repo operations. Since May, the central bank had been a net purchaser of repos to a substantial degree. However, the volume of outstanding treasury bills had not changed, so the banks have been shifting resources from the repo market to treasury bills, hence lowering the rates. The staff believed that to be a temporary situation. The authorities were trying to find out whether a slightly lower treasury bill rate might transmit into corresponding changes in both deposit and lending rates to spur higher private sector credit growth.

On the exit strategy, although it was not the intention of the staff at the present stage to elaborate on the nature of the exit strategy, it did try to analyze in quantitative terms—using debt, revenue, and growth indicators—whether policies under the current program would eventually lead to a sustainable position for Kenya, the staff representative elaborated. The staff would provide a deeper analysis on the exit strategy in the context of future program reviews and the next Article IV consultation.

Ms. Nikitin made the following statement:

I would like to thank the staff for an interesting set of papers and Mr. Usman for his comprehensive statement. I join Mr. Callaghan and others in commending the new government for a good start in tackling the governance problems and for implementation of wide-ranging governance measures, which have paved the way for today's discussion. I support the authorities' request for a PRGF arrangement, but like others, I believe that there are still many risks to the program implementation. As I broadly share the staff's assessment both in the PRGF report and in the Joint Staff Assessment on the PRSP, I would only like to raise a few issues related to fiscal policy and donor coordination.

First, one of the risks mentioned also by the staff is an increase in tensions within the ruling coalition, which could delay the implementation of critical reforms. Taking into account these political risks, I was happy to read both in Mr. Usman's statement and in the staff report that the macroeconomic framework of the new program is consistent with the budget that was approved in August. However, I got a little bit puzzled after my authorities, who are present in Nairobi, told me that the Parliament has not passed the appropriations bill to authorize the implementation of the full budget. I would appreciate if staff could elaborate on the budget process, especially on whether the August budget, the appropriations bill, and the fiscal program of the new PRGF arrangement are consistent with each other, and also on whether the necessary authorization to implement the budget is in fact in place.

Second, I strongly support the authorities' efforts to improve public expenditure management, which currently is far from satisfactory as is evident from accumulation of expenditure arrears. Like the staff, I believe that improving public expenditure management is an essential tool in aligning the budget process with the economic recovery strategy (ERS). Like Mr. Scholar and Mr. Williams, I think that the December dead-line for the full economic recovery strategy seems quite ambitious, and this actually brings me back to my first point on the budget process, namely, I would be interested to hear in more detail how and at what stage the economic recovery strategy feeds into the budget process.

Finally, a few words about donor coordination. According to information I have received from my authorities, there is a feeling among bilateral donors that information sharing by the Fund is unsatisfactory. I would like to stress once again the importance that we put on good co-operation and information sharing between the Fund and donors, and I encourage upcoming missions and the Fund's Resident Representative in Kenya to be more engaged with the donor community. I, of course, welcome any remarks the staff may have on this issue.

With these comments, I wish the authorities all the best in their efforts to implement their economic program successfully.

Mr. Yakusha made the following statement:

In most respects, the new government has been off to a very good start. It has initiated a number of important reforms, such as the passage of anti-corruption legislation, the establishment of anti-corruption institutions, and the replacement of a large part of the judiciary. This is in sharp contrast with Kenya's recent past and it might therefore be tempting to become overly optimistic. The challenges nevertheless remain enormous, external factors are not favorable, while the pace of economic reforms continues to be rather slow. The new government deserves support for its reform agenda and our assistance should help improve the chances of success. I therefore support the proposed three-year arrangement, in spite of some, in my view, overoptimistic expectations. At the same time, I would like to stress that after almost a year in office, the government's honeymoon is over. At the first review, in addition to more initiatives and good intentions, we would very much like to see tangible results in the fight against corruption, in increasing poverty-related spending, and in overall economic reform.

As for the PRSP status report, I agree with the joint staff appraisal. However, while the staff expects that the final version of the Economic Recovery Strategy will be ready by December, many donors seem to view this time frame as rather optimistic. Although the progress report can be accepted as the basis for a first disbursement under a new PRGF arrangement, the first review should only be completed after approval of a full ERS and action plan, to ensure that the PRGF-supported program is indeed in line with the authorities' overall poverty reduction strategy.

As for the content of the ERS, I would like to reiterate our view that, while we of course support a broad-based participatory process, the result should not be just a 'wish list'. The authorities' action plan should be clearly prioritized and realistic, taking account of government resources and even some contingencies in case of possible shortfalls or delays in donor financing. Previous drafts of the ERS have, in our view, not addressed this concern satisfactorily.

I agree with the priorities set under the proposed PRGF arrangement. The key factor determining success is tangible results with regard to improving governance and fighting corruption. Here I note that the conditionality under the program largely focuses on public finance issues, less so on governance. I understand from the staff that governance issues are included in World Bank conditionality and were more difficult to include under this PRGF-supported program. Nevertheless, in Kenya, the fight against corruption is macro relevant. Regardless of the formal conditionality under the program, it should be clear that if the authorities' anti-corruption momentum stalls and if tangible results fail to materialize, there is no scope to continue with the program. In view of Kenya's regrettably poor track record, it would have been warranted to make this more explicit by including it in some way in the conditionality—e.g., assess the number of corruption cases brought before court and rulings made. Currently, the eight court cases against individuals charged with corruption have been stalled, because the constitutionality of the anti-corruption courts has been challenged. The matter has been referred to the Chief Justice. The staff report mentions that public servants under investigation have been suspended. The real test case, however, will be the way the government deals with ministers against whom serious corruption allegations have been made.

Finally, on the program assumptions with regard to expected donor funding, an increase from 1.9 percent of GDP last year to 9 percent of GDP next year and even more in the years ahead is projected. For next year, I believe this assumes some USD 37 in donor support per capita, and this seems to be a very high figure. I understand from the staff that they view the projections as realistic, given the levels of support from neighboring countries. I would assume it is entirely justified from the viewpoint of needs. I hope nevertheless that the staff has a plan "B" if the program will not in fact be fully funded. I would also appreciate some PDR views on how we should deal with this and other programs if they are not fully funded.

Mr. Villavicencio made the following statement:

Like others, we thank the staff for an informative set of papers and Mr. Usman for his helpful statement. Combating corruption along with the implementation of a comprehensive economic program and structural reforms will allow Kenya to benefit from its large economic potential, and will pave the way for achieving poverty reduction. Having said this, we support the new three-year arrangement under the PRGF, and we will limit our statement to some remarks on few specific topics.

We think the Kenyan authorities are commendable for their efforts to fight corruption and improve governance and accountability. At the same time, decisive steps have been made to pursue macroeconomic stability and improve the prospects for sustain growth. Nevertheless, the challenges facing the authorities are huge and only with adequate and timely technical assistance and financial support from the international community, will Kenya be ready to resume growth with stability.

We share the view that, to assure the support of the international community, the Kenyan authorities need to show in action their commitment toward the program. In this regard, we welcome the medium-term strategy designed by the authorities to push forward the economic program and we encourage the authorities to move fast in the consultative process to convert this strategy into a full PRSP.

Notwithstanding the efforts already made by the authorities, we concur with others on the need to place governance issues at the top of the policy agenda. However, given the limited resources and capacity constraints, the authorities would have to determine an order of priorities to carry out the economic strategy. Restructuring public finances to reduce the deficit and pursue fiscal sustainability is a much needed step. In this vein, we welcome the authorities' intention to increase revenue collection and strengthen tax administration. On the expenditure side, besides cutting non-essential expenditure, we are encouraged by the decision to reinforce expenditure monitoring and control, in particular that of social and poverty-related spending. Measures directed at improving budget formulation and execution are welcome, and we encourage the authorities to extend them to the local government level, in preparation for the transfer of spending responsibilities to them. In this specific area, it seems to us that a strong effort at capacity building will be needed.

Structural reforms supportive of the efforts to resume job-creating growth and to reduce poverty must be speeded up. We share the staff's view on the need to strengthen the weak financial system and to reinforce bank supervision. The transfer of banks regulation and supervision to the central bank is a welcome step. However, we concur with Mr. Steiner and Mr. de Silva on the need to give appropriate support to the central bank on its expanded role.

Regarding structural reforms, we encourage the authorities to advance with the restructuring of public enterprises and privatization, since they are crucial for increasing economic efficiency and achieving fiscal sustainability in the medium term.

On trade policy, we agree with the authorities' medium-term strategy, although, like other Directors, we think that to improve external competitiveness, besides maintaining the existing flexible exchange rate framework, reforms are needed in the labor market to increase flexibility.

According to the government's Economic Reform Strategy, most of the poor live in rural areas, and the program focuses on reforming the agricultural sector and encouraging the growth of medium and small scale enterprises. While we support this approach, we are concerned about the capacity constraints that may arise. Therefore, we call on the authorities to give this approach a careful analysis to identify the need for technical assistance and financial support.

To conclude, the program involves some risks, as indicated by the staff, which would have to be addressed, such as the possible terms of trade shocks, the transitory shortfalls in aid inflows, and adverse regional and domestic political developments. In this regard, we encourage the authorities to follow a strict monitoring of the program to make any correction they consider necessary on a timely manner.

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

Mr. Alazzaz made the following statement:

Kenya's request for a new PRGF-supported program represents a milestone in the country's renewed development effort. The consequences of more than a decade of sustained economic decline is now reflected across a wide range of indicators, including a drop in per capita real income to some 60 percent of the average for Sub-Saharan Africa. The income drop has also continued with a further deterioration last year in both the fiscal and external payments positions.

The new administration has made an evident effort to reverse the unfavorable trends. Specifically, I note the implementation of the reforms carried over from the last PRGF arrangement. Also reassuring is the development of the authorities' own broad-based policy framework under the Economic Reform Strategy for Wealth and Employment Creation (ERS). Going forward, I welcome the confirmation of the authorities' policy commitment in Mr. Usman's statement.

I broadly agree with the staff appraisal. I also look forward to future occasions for discussion of the program's progress. At this stage, I will only add a few broad remarks for emphasis.

First, the program's emphasis is rightly on governmental reforms aimed at ensuring investor confidence in the country's institutions and practices. The actions included in Box 1 of the staff report comprise an ambitious but realistic agenda for rebuilding the country's image as a business destination. Steadfast implementation of the agreed policies is critical in that regard.

Second, I agree with the staff that the Economic Reform Strategy (ERS), which builds on the earlier I-PRSP, is well in hand as an adequate basis for proceeding with the proposed PRGF. The envisaged far-reaching changes clearly amount to a demanding agenda. Here, I agree with Joint Staff Assessment (JSA) that, considering the limitations of implementing capacity, it is important to prioritize a few actions for greater impact on growth and poverty reduction.

Third, on poverty diagnostics, like the joint staff assessment, I welcome the authorities' intent to help supplement the past poverty assessments by drawing on the knowledge emerging from work on the ERS. Using synergies from household surveys and other instruments that shed light on the conditions of the poor is also important. Further, I see dedicated poverty surveys as more in line with the expertise traditionally associated with other concerned organizations, including the World Bank.

Finally, I endorse the program's central focus on strengthening the fiscal position. Indeed, the Fund's advice for improved fiscal management has traditionally covered many of the issues that are now grouped in programs as problems of governance. I note here particularly the importance of effective spending controls in the light of the program's orientation for priority social and economic outlays. I also share the staff's stress on the priority for improved tax administration and civil service reforms.

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

Ms. Vtyurina made the following statement:

The reality is that, in the past 14 years, Kenya has only completed successfully one out of four programs with the Fund. The track record under the most recent PRGF is not encouraging whatsoever. At the same time, it does seem that the new government is working diligently to implement the election promises, especially in the area of improving governance where the flight against corruption is going strong. At the same time, divisions within the coalition are strong and could undermine the government's strides in the reform area.

Having said this, we do welcome the PRGF arrangement. Together with the ERS, this opens doors for normalizing relations with donors and embarking on the reform effort so overdue for Kenya. While welcoming the objectives under both reform blueprints, we have noticed that both are a bit too ambitious, especially the ERS. While this should be an encouraging sign, and I am glad to share Mr. Kalinga's optimism, the underperformance on the job creation front, growth and investment can dampen the belief in the government's seriousness about reform implementation as was the case previously. After all, even the staff projections in Table 6 suggest that the programmed GDP growth data are some way off the government's ambitious targets, at least until 2006/07. Investment projections, while in line with the staff's, are exceptionally bold. While improved public-sector governance and other reforms should help revive the economy, perhaps, more caution and realism in the projections would still have been more appropriate.

In the fiscal area, the situation has deteriorated dramatically and can hardly be sustained without donor support. The agenda for improving the fiscal position is a tall order, while appropriately so. We commend the authorities for the commitment to these reforms, but we are somewhat disappointed by the fact that none of fiscal measures has been included in the conditionality. This Chair argued in May that, given the importance of overhauling the tax system, at least some of the tax measures listed in paragraph 15 should have found their way into the conditionality table for the years 2003/04. Could we expect to see some of them included in the conditionality past March 2004? This goes along the lines of comments made by Mr. Scholar and Mr. Williams and other Directors. While we are not advocating overburdening of conditionality, we hope that the staff can sort through the suggestions and come up with an adequate adjustment.

We welcome the attempts to streamline the public sector wage policy, and, indeed, it is quite appropriate that a few items in the conditionality are devoted to this issue. We would warn, however, not to be carried away by overly concentrating on this one issue in reducing corruption. While governance issues could be addressed through better pay at the lower level of the civil service framework, in many instances corruption is usually more damaging when executed by the upper echelon of the government where incentives are much higher.

We, thus, continue to urge the government to demonstrate its seriousness in fighting corruption through high profile actions. Finally, we are somewhat confused about the plans for establishing an independent Anti-Corruption Commission. It seems that the Constitution Review Commission deemed its independence impossible. Could the staff elaborate further on this issue of independence, since this was the most contentious point in the past and it is still the benchmark under the program.

We continue to highlight that privatization is not the only means to an end, especially in a country with a history of grave governance problems and high unemployment. We continue to recommend to the authorities to be extra careful in designing and implementing the privatization process. Transparency and establishment of social safety nets should be the main elements of the process. Increasing the efficiency of viable enterprises before their sell-off would also increase the gain from sales.

We very much share the staff assessment of the developments and challenges of monetary and exchange rate policies. The increase in reserve money well above the target was unwelcome and we hope it can be reversed soon. At the same time, like Mr. Shaalan and Mr. Shbikat, we see pressures on the exchange rate stemming from the assumed increase in donor inflows, which will need to be sterilized. This could lead to the appreciation and, as in 2003, add to concerns about competitiveness. Yet currency appreciation should not be considered the primary reason for the sluggish performance of some exports in recent years. Since the exchange rate is not the sole determinant of the country's competitiveness, it would be important to address a vast array of non-price issues that inhibit competitiveness.

The staff is absolutely right in emphasizing the substantial effect that the conduct of monetary policy has on the state of the banking system. The environment with too much liquidity where the government is reducing its domestic financing and banks are unwilling to extend credit to the private sector can easily become a trap for the system. In addition, low domestic interest rates would be very attractive to the government, but we urge it to resist the temptation to wander off the path of reducing domestic borrowing. The question also arises regarding other possible investment alternatives the banks may choose to resort to. Supervision should be enhanced so that instances of quick gain but high risk operations are prevented. On the issue of the interest rate spreads, we note that there is a continuous PC on "no imposition of controls by the government or the CBK on the determination of interest rates." At the same time controls are in place, thanks to the Donde bill, unless it has been reversed. Staff comments would be appreciated.

Finally, debt sustainability analysis, while promising, highlighted the usual suspects in the risk area, that is, interest and exchange rates and external shocks. Concessional assistance would be key to preserving sustainability, as would be Paris Club restructuring. At the same time, donor support is a volatile parameter, thus, it is imperative that that the authorities take bolder steps to become self-sufficient. Finally, we would commend the CBK for continuing to lengthen the maturity profile of government debt, which brought the ratio of bonds to bills to 70:30. The growing importance of medium-term bonds should also facilitate the development of capital markets.

Mr. Boitreaud made the following statement:

Let me start by commending the staff for an excellent set of papers, which provide us with a comprehensive and well-balanced report on Kenya's situation and prospects for an arrangement with the Fund. We support the proposed program and would like to emphasize a few points.

Like many Directors, we believe that the authorities are implementing a sound and appropriate strategy for reforms, putting the onus on improving governance and the business climate. In this regard, the list of measures already undertaken, as detailed in Mr. Usman's helpful and candid statement, is rather impressive. In particular, the fact that the government has implemented all the governance measures that had not been undertaken under the previous program bodes well for the future.

Indeed, the new administration appears to be determined to forcefully address the main constraints weighing on the Kenyan economy and, just as importantly, it seems that they have convinced the population of their determination. This is, nevertheless, only the beginning of a long and arduous journey, and strong resolve, as well as political acumen, will prove essential in the coming months and years. As mentioned by Mr. Bennett, steady progress in the fight against corruption and sustained commitment to the reform agenda will be key to mobilize donor assistance, attract investors, and lay the groundwork for strong economic growth the Kenyan authorities are seeking.

Concerning the PRGF arrangement, we think that the program is well designed and balanced, in particular the structural conditionality detailed in Box 2 of the report, which seems appropriately streamlined. All in all, the PRGF objectives appear achievable and, at the same time, sufficiently ambitious to bring the country back on the road to recovery. However, being achievable does not mean that the program's objectives will be easily attained, given the size and the difficulty of the challenges facing the authorities and looking at the recent history of Kenya's performance. For these reasons, we believe that it would be more prudent to include alternative scenarios—higher and lower cases—in future reviews, as proposed by Mr. Scholar and Mr. Williams.

On the content of the program, I have two remarks. First, we fully share Ms. Nikitin's and the staff's insistence on rapidly improving public expenditure management, notably to ensure a better tracking of poverty spending and to maximize the benefits of many international assistance. Strengthening public expenditure management will indeed be indispensable to convince donors and, consequently, to achieve the authorities' ambitious projections of donor financial support.

Second, public enterprise reform will be a crucial step toward enhancing growth potential. Many state-owned enterprises need to improve their management system, increase their transparency and their accountability, and introduce rules of corporate governance. In this respect, privatization remains the ultimate objective, but we would caution the authorities against rushing to sell public companies to private investors.

We share Mr. Shaalan's and Mr. Shbikat's views that privatization is not, per se, an accomplishment, and that the manner in which it is carried out is what will make the process beneficial for the economy. We therefore advise the authorities to adopt a gradual approach, focusing first on improving governance and transparency of state-owned enterprises. Indeed, badly managed privatization would weaken the whole governance agenda. It would also prevent the state from maximizing the financial receipts generated by the sale of its assets. Last, but not least, it would undermine domestic support for economic reforms and liberalization. In a nutshell, like Ms. Vtyurina, we recommend pragmatism in this area.

We thank the staff for a comprehensive DSA. As mentioned by Mr. Kalinga at the outset of the discussion, the Paris Club has provided its financing assurances based on the rescheduling of the pre-cutoff date maturities without deciding yet on the terms. As shown in the debt sustainability analysis, several scenarios are possible, and Paris Club creditors will have to make a decision on the basis of the Fund's DSA of Kenya's payment capacity and, of course, of the comparability of treatment with other creditors.

In this respect, the medium-term impact of any rescheduling on Kenya's private creditors must be analyzed carefully, in particular with regard to the country's objective to attract substantial FDI flows in the future. We should also keep in mind that Kenya has never requested debt reduction to maintain its credit rating vis-à-vis its external creditors. All in all, these issues are complex, and the authorities should prudently balance the pros and cons prior to finalizing the terms of their request to the Paris Club creditors.

Finally, like others, we are a bit disappointed by the limited coverage of poverty issues and of the likelihood of the country achieving the MDGs. We expect more information on this issue in future reviews, and would favor a stronger link between policy recommendations and their impact on poverty reduction in line with our recent policy discussions on the role of the Fund in low-income countries. Having said that, we wish the authorities all the best in their endeavors.

Mr. Fabig made the following statement:

Like other speakers, I thank the staff for a well-written set of papers and Mr. Usman for his helpful statement.

Kenya faces the daunting challenge of restoring strong economic growth, of restoring fiscal sustainability, and of turning around the downward trend in key social indicators that Table 5 of the staff report highlights so dishearteningly. This table also drew the attention of Mr. Callaghan. We very much welcome the first measures the new government has taken in the field of governance and anti-corruption. We are also encouraged by yesterday's announcement of President Kibaki to privatize Telcom Kenya by June 2005, and if I understand the reports correctly, this privatization will be very much in line with the cautious strategy Mr. Boitreaud has just outlined. We hope that these first measures by the new government will soon be followed up by fiscal consolidation, improvements in public expenditure management, public enterprise restructuring, financial sector reform, and comprehensive trade reform.

We fully support Kenya's request for a three-year arrangement under the PRGF. We thus support the entry of Kenya into IMF financing. We commend both the authorities and staff for having worked out a truly comprehensive economic program. The key elements of the program are well-focused and the reform measures are well-sequenced.

Against this backdrop, I have only five quick points:

First, we would like to stress, like many other Directors, the crucial importance of governance and anti-corruption measures. The first steps in this area are most welcome but should not lead to any early form of complacency. Setting up anti-corruption institutions is the easy part. Eradicating deep-rooted corruption in a sustainable way is the hard part. I can fully associate myself with the remarks made by Ms. Lundsager and Mr. Dohlman in this regard.

Second, we would like to point out that financing under the program is still quite insecure. Major agreements—e.g., with bilateral donors—have yet to be completed. Ms. Lundsager and Mr. Dohlman, Mr. Bennett, and Mr. Callaghan also touched on this point in their statements. It is crucially important for these agreements to eventuate that the Kenyan authorities implement the reform agenda in full and without delay.

Third, we would like to have seen a more pronounced cutback of military expenditures, especially given the increases of the past. In fact, defense spending will continue to rise in the program scenario of Table 7.

Fourth, we welcome the efforts of the new government to work towards a full PRSP in the framework of their Economic Recovery Strategy for Wealth and Employment Creation. However, as the JSA points out, there are still quite a number of improvements that should be considered, not least identifying priorities. We encourage the authorities to take the advice of the JSA on board. We look forward to the completion of the full PRSP, but like Ms. Lundsager and Mr. Dohlman and Mr. Scholar and Mr. Williams, we consider the December 2003 deadline to be rather ambitious.

Fifth, like Mr. Scholar and Mr. Williams and Mr. Boitreaud, we see considerable merit in alternative scenarios to be included in future documents as they will help build the case for reform.

To conclude, let me reiterate our satisfaction with the way the new government has started to reform the country. Germany is mindful of the fact that this IMF program will be a significant boost for the Kibaki government and will strengthen the reformers in Kenya. Reuters reported today that we meet today to, quote, "decide Kenya's fate." While I do not want to play down the significance of today's meeting, I still believe that Kenya's fate lies primarily in its commitment to reform. As President Kibaki said yesterday when launching a five-year investment plan, quote, "Doors that were closed…are now wide open and when they are shut please tell us." On behalf of Germany, I say, "Will do." Germany stands ready to support the authorities' reform drive in many ways, including in the Paris Club, and we wholeheartedly wish them all the best in their challenging endeavors.

Mr. Zurbrügg made the following statement:

Talk about long gestation period for program negotiations! Since the program with Kenya went off-track three years ago, we have had many heated Board discussions on the major stumbling block, namely governance. During this period, it was difficult to be optimistic as regards the prospect of the new program. Therefore, I am happy that we are finally at a point where we can discuss a new PRGF-supported program. Like other colleagues, I commend the authorities for having taken a number of important steps against corruption and thereby demonstrated that they take their election pledge seriously. I support the request for this arrangement. Of course, it is still too early to judge the authorities' success in their fight against corruption. Given that the problem is huge and deeply entrenched, it will take considerable time to tackle it. It is thus important that the authorities maintain their efforts, and that the PRGF-supported program appropriately focuses on governance.

However, I have to admit that I have some concerns regarding the content of the program. They are threefold: The program entails insufficient fiscal adjustment, it is based on overly optimistic assumptions, and it contains insufficient structural conditionality.

As to fiscal adjustment, I miss the strong up-front fiscal consolidation, which was considered a key element for restoring fiscal sustainability in last year's Article IV report. Even under the low-growth scenario, the primary surplus was rapidly achieved. Now, both the overall deficit and the primary deficit are set to widen, while the reduction in domestic borrowing is entirely based on external assistance.

In his statement, Mr. Bennett noted that, after having heard Jeffrey Sachs, he could not help but notice how little attention the MDGs received in the staff report. For me, it was a bit the other way around: after having read the staff report, I could not help but notice how much Kenya's economic strategy is based on the Jeffrey Sachs approach, namely, to boost public spending and hope for donor assistance with a view to achieving the MDGs as soon as possible. This is a risky strategy that leads to large financing needs and substantial dependence on donor assistance. Like Mr. Le Fort and Mr. Segura, I wonder whether the envisaged spending does not stretch implementation capacities. And I agree with other Directors that the authorities should consider contingency plans and safeguards in case donor support falls short of expectations.

Like Mr. Callaghan, I was also surprised that, on the expenditure side all savings on wages and benefits are neutralized by expenditures on the civil service reform. I also agree with him that the envisaged improvements in revenue performance are relatively modest. Furthermore, there seems to be considerable scope for improving customs procedures and administration, which should offset revenue losses due to trade liberalization. Such improvements, particularly in port operations, would also help reduce corruption and smuggling. Lastly on the fiscal side, I welcome the strengthening of expenditure management, but I miss a more specific reference to debt management.

My second concern is that the program seems to be based on rather optimistic assumptions, not only with regard to the pace of implementation, as noted by Mr. Scholar and Mr. Williams, but even if the program were implemented as envisaged. I particularly wonder what the basis is for the high export growth. Moreover, having the recent discussion on the lessons from the crisis in Argentina in mind, I also wonder whether the links between the planned structural reforms and growth assumptions have been carefully and critically assessed.

My third concern is in the structural area. Like Mr. Scholar and Mr. Williams, and Mr. Bennett, I would have welcomed more structural conditionality, particularly in the area of governance and state-owned enterprises. That improving governance is absolutely crucial has been stressed by all Directors, but it is also absolutely crucial that the distortions that are created by the public enterprise sector are addressed and that the privatization process is accelerated. It is important to stress that there is no fiscal room for subsidizing inefficient state-owned enterprises or parastatals. I took note of several colleagues' comments on the necessity not to rush to process, in order to ensure a successful privatization. However, we should not forget that while waiting for profitability of these enterprises and possibly higher sales prices, they are an important and drain on scarce fiscal resources. These costs could easily be higher than the eventual privatization revenues. Of course, I agree with Ms. Lundsager and Mr. Dohlman and the comments of Mr. Boitreaud that a strong legal framework and a transparent process are preconditions for the privatization.

Privatization must also be seen as an important element of improving the investment climate. Inefficiencies in the telecommunications system and in the system for power distribution, as well as high costs of electricity have been identified as major impediments for private investment. These issues have to be addressed, and they need to be addressed quickly in order to achieve the foreign direct investments envisaged under the program. The program should thus put sufficient emphasis on these issues.

Mr. Vermaeten clarified that his chair was supportive of the idea that the baseline scenario under the program should be based on realistic assumptions of donor commitments. That said, however, the staff should also consider incorporating into its future reviews multiple scenarios that included more optimistic and less optimistic projections, as well an analysis on the level of resources needed to reach the Millennium Development Goals.

Mr. Santos made the following statement:

We thank the staff for producing a candid report. Kenya is another country where reasonably good progress achieved toward macroeconomic stability—and in difficult circumstances, we should recognize—contrasts with a poor record of reform implementation that has kept economic activity in check. This disappointing growth record reflects both weak growth in total factor productivity and slow factor accumulation. Investment has been held in check by a general lack of confidence in institutions and policies, and employment growth has been constrained by labor market rigidities, namely, in the wage-setting mechanisms, which have contributed to the emergence of a large informal sector.

This development of a dual labor market, given that the relative importance of the formal sector has been steadily declining, has obvious negative effects on growth as productivity in the informal sector tends to be lower, and on fiscal policy due to a narrowing of the tax base. However, it is equally true that, at least over the short term, the informal sector constitutes an important safety net that has prevented poverty and unemployment to reach even more dramatic levels.

> In these circumstances, the program we are about to approve correctly focuses on the implementation of structural reforms that allow Kenya to re-establish growth in line with the potential of its economy, and even to increase that growth potential. As in other developing countries, reform is not easy, as it generates winners and losers, at least in the short run. In the case of Kenya, however, we feel that the implementation of a broad program of structural reforms can be helpful, at least for two reasons.
>
> First, when compared to purely macroeconomic policy constraints, structural reforms alleviate the distributional trade-offs by raising economic efficiency, strengthening growth prospects, and enlarging resource availability.
>
> Second, contrary to individual reforms that may exacerbate distributional conflicts, a broad-based reform program may both amplify the efficiency gains and generate a sufficiently large range of winners to garner larger support.
>
> We would underscore the importance of rehabilitating the banking sector, as problems of a structural nature are hampering the transmission mechanisms of monetary policy. Indeed, lending rates are to fully reflect the variable level of inflation and contribute more decisively to a pick-up in economic growth, as banks have maintained large spreads for reasons well-documented in the report.
>
> This said, we trust that the policymakers in Kenya will deliver on their commitments.

Mr. Williams, in response to Mr. Zurbrügg's comments, said that his chair's main concern with the current program was that the Economic Recovery Strategy had yet to be finalized, so it would be difficult to project the level of resources needed. Therefore, like other institutions such as the World Bank and the European Union, the Fund should be slightly cautious about the program's assumptions, and include the use of alternative scenarios in future program reviews. On privatization, while his chair agreed with Mr. Boitreaud that it was a politically sensitive issue which should be proceeded with caution, in the longer run the authorities would need to demonstrate to the people that public enterprises were a drain on the budget and that restructuring and eventual privatization of those enterprises would be beneficial.

Mr. Salleh associated his chair with the views of Messrs. Daïri, Wang, and Shaalan, and supported the proposed program.

The staff representative from the African Department (Mr. Kalinga), in response to further questions and comments by Directors, made the following statement:

Regarding political tensions within the ruling coalition and their effects on program implementation, the staff does not have expertise in this area. The staff relies heavily on the assessments of principal embassies and civil society to gauge the political environment. Those assessments have been candid, and the staff has included political economy analysis that is more than normally required in the staff report. These political tensions have a bearing on the program and the staff will continue to monitor them. So far, they have not impeded progress in the implementation of key reforms. However, the staff is unsure about what may happen in the future.

On the approval of the budget, under the Kenyan budget process, by the end of the first three months of the fiscal year—which began on July 1—parliament must approve the overall aggregate budget and allocations for six months. That was done in August, and the aggregates approved are the ones embodied in the Memorandum of Understanding. Similarly, the six months' appropriations that stem from that also follow from the approved budget and, correspondingly, the memorandum's assumptions. However, discussions on the detailed ministerial appropriations continue. The authorities have informed the staff that they expect passage of the appropriations bill during the first week of December.

On how the Economic Recovery Strategy will fit into the budget system, the key instrument is the medium-term expenditure framework. In Kenya's case, this instrument remains weak mainly because, in the past, they did not have any good development expenditure where this instrument played a major role. There were no resources from the donor community, and virtually all recurrent expenditures were covered by the recurrent budget, with little left for development expenditure. In addition, much of the donor funding was done off-budget. Consequently, over the last 18 months, the authorities have been trying to develop an instrument to link the medium-term expenditure requirement needs of each ministry with the output and outcome requirements. That refinement process, which requires costing of broad entities and input/output, takes time. In Uganda, it took five years. In Kenya, the authorities have just begun the process. Within the scope of where we are now at the beginning, the main focus should be on the input side, on resources, before gradually moving to the output side, which is more focused on the attainment of the MDGs. The staff's understanding is that this issue will not be further discussed, even at the CG meeting. It is not due to a lack of will, but because the necessary elements and understanding of the system need to be put in place.

There was a question about the Fund's relationship with the donor community. From the staff's side, the impression is that in Kenya contacts between the staff and donors have been much stronger. However, the staff will look into the issue at the CG meeting and report back to management on the potential problems so that they can be rectified. Each staff mission that goes to

Kenya meets with all the donors during the first day. In addition, at the end of the mission, the staff meets with donors to report on the outcome of the discussions with the authorities. Even in the run-up to the current Board discussion, given the delays that took place, the Resident Representative arranged meetings with the donor community and the Paris Club to brief them on the problems encountered regarding the DSA. If there are shortcomings, which are regrettable, the staff will address them and include in the report on the fiscal review a section on the donor coordination mechanisms and the improvements being made.

On the timetable for completing the full PRSP, the staff's understanding is that the authorities had proposed a December deadline to coincide with the forthcoming CG meeting. In terms of the Fund's requirements, a full PRSP is not needed until the first program review, which is scheduled for discussion by the Board some time in May 2004. The authorities have requested that, after the CG meeting, in the context of the staff visit in December, the staff develop a few more scenarios and begin to look into ways of expanding the medium-term framework to a longer perspective in order to incorporate the MDG needs and resource requirements. Thus, the staff's impression is that after the review by the CG meeting, there will be more work to be done before the PRSP is fully completed, including more internal discussions with civil society.

On why there is limited conditionality on governance, Directors will recall that most of the prior actions were on governance issues. Therefore, one reason is a rebalancing of conditionality. The other reason is that the staff is unsure that the Fund-supported program should be having specific conditionality in areas such as the judiciary. Other donors—the European Union, the World Bank, and other bilateral donors—have been holding discussions with the authorities to drive forward the governance agenda. In the economic areas of governance, the staff still intends to maintain a sizable proportion of conditionality in future reviews.

On the uncertainty of program assumptions with regard to donor resources, it is a problem in every program country, especially in Kenya where donors had broken most of the contractual arrangements. It is important to note, though, that Kenya has potentially a much bigger donor base than either Uganda or Tanzania, which at the moment receive close to 10 percent of GDP a year in aid. This is information that the staff has received from donors. The question is the pace at which donor support is likely to flow in. The second question is the management of donor flows in the event of shortfalls. The staff has had some experience in that area. The problem revolves within budget cycles: how can the staff rectify a mistake in projecting donor support—and sometimes mistakes can be big, beyond 1 percentage point of GDP—especially in programs where certain expenditures have to be protected? It is for this reason that most Fund-supported programs, especially in Africa—and we are trying to have it in Kenya too—build in a large foreign reserves base of at least four months of imports, so that any deviation of donor aid of around 1 percentage point of GDP can be contained while protecting social outlays. The present foreign reserves level of Kenya, at 2.7 months of import, does not provide a comfortable buffer. In 2003, most of the projections of donor support are based on actual commitments. In the outer years, there is more uncertainty. As we move toward the budget year, the staff will be trying to refine the program to build a cushion, knowing that within each of the CG cycles these assumptions on donor support are reviewed.

On the inclusion of revenue conditionality in the program, initially the focus has been on improving customs, and the authorities are making progress on that front. The limitation has been getting technical assistance, which the staff now believes is in place. In future programs, it is the staff's intention that, once the related technical assistance are in place, the relevant revenue conditionality will be included.

Regarding the establishment of an independent anti-corruption unit, this was one of the key areas of discussion under the last program. However, I must point out to the Board that in 1992 the Fund required a conditionality that the appointment of the Attorney General must be for life. The government agreed and the current Attorney General has been the most corrupt. The current Constitution Review Committee is looking at all these issues, with a view to trying to craft a mechanism that will protect against such eventualities. The staff has visited embassies to canvass views on whether this is a step in the right direction. We have been told that the safeguards being built may be adequate. Given our earlier move too hastily in one direction, we will try to be a bit more cautious. We will report back to the Board when we have gathered more information.

Regarding the Donde Act, it was never implemented. Immediately after it had been passed by parliament, there was a court challenge and it is still before the Supreme Court. The authorities' intention is to change the Banking Act and the Central Bank Act, and to remove the Donde Act. The authorities do not actually need the Donde Act; section 44 of the Banking Act has the same provisions, plus more, that the Donde Act has. The authorities initially wanted to apply some aspects of section 44, which would have allowed them to begin to control some bank charges. However, they have agreed to review those sections of the Banking Act. There is still significant pressure in parliament to activate the Donde Act or Section 44 of the Banking Act. The staff might need some lever at some stage to make sure that this can be dealt with. We will continue to hold discussions with parliamentarians and other officials on this issue.

On the limited coverage of poverty issues and MDGs, the staff is working to improve Kenya's capacity and address its knowledge constraints. The motivation to do more is there, but resource constraints may be an issue.

On defense expenditures, they currently constitute 2.3 percent of GDP and are projected to decline to 2.2 percent of GDP in 2004 and to around 1.7 percent of GDP thereafter. They remain stable over the next two years mainly because of sizable commitments, including a debt payment for equipment already bought.

On the question of insufficient fiscal adjustment, this is a technical issue to some degree. In the staff's work in many countries, including Uganda, we found out that, in order to fully meet some of the requirements of poverty reduction, World Bank resources are needed as they are very concessional and an appropriate mechanism for feeding in other donor assistance. That automatically implies that to systematically address these issues, some borrowing is needed. It appears the problem may be that the staff's estimation of the fiscal deficit does not take account of the component of new resources. Some Directors have pointed out that perhaps if we build some of this into the picture, we would be bringing together more symmetry between our treatment of debt and fiscal matters. Hence, as long as some World Bank resources are available, the path of the primary deficit in the near term—where we are focusing on poverty issues—remains fairly stable, especially when the World Bank plays a significant role in the near term. When other donors finalize their commitments or enact legislation to resume their programs, then the World Bank can scale back its lending.

On export growth, the staff assumes that, over the next two years, it will be lower compared to the last two years. The reason is that Kenya's exports at the moment, unlike most other African countries, consist of about 60 percent nonprimary, manufactured goods to Africa, and only 40 percent primary goods to the rest of the world. The staff is cognizant that part of the recent growth of around 16 percent per year for the last 2-3 years was premised upon opening up the COMESA market, which had enabled Kenya to be the main player in the subregion, and that this may not last. We are hoping that with more aggressive trade reform over the period ahead, which gears exports less to the subregion and more to the global market, Kenya might be able to recapture that growth rate over the medium term. But the figures in the current program build in a much lower export growth rate of 5-7 percent in the initial 2-3 years, before projecting a pick-up in subsequent years.

On requiring greater conditionality on the public enterprise sector and governance, the staff will consider the issue in future program reviews, in full consultation with the World Bank staff.

Mr. Usman made the following concluding statement:

On behalf of the Kenyan authorities, I would like to take this opportunity to once again thank the staff for a balanced set of reports on Kenya and for comprehensive responses to issues raised by Directors. I would like also to thank members of the Executive Board for their understanding and support and for their constructive views and valuable advice all of which I will, as usual, convey to the Kenyan authorities. The authorities remain highly appreciative of this understanding and support. The direction of discussions in the Board today will go a long way in further strengthening the authorities' strong resolve and determination to forge a head with adjustment and in pursuance of sound policies for the achievement of sustainable, job creating growth and poverty reduction.

As I have stated in my statement, the Kenyan authorities do recognize the many challenges they face, including the raised expectations of Kenyans and the government's ability to deliver on its election promises. I agree with Mr. Callaghan that the reform agenda necessary to revitalize the Kenyan economy is substantial and that the authorities will need a focused, prioritized strategy with due regard to capacity constraints and donor support. I also cannot agree more with Mr. Bennett that "since the program relies heavily on a major influx of donor support, and this will definitely not come to fruition if there is a sense that the government is losing its resolve." I agree that the Government has to continue with the strong resolve they have shown so far in forging a head with difficult reforms, and which is showing noticeable results in the short period since they attained power.

I have taken note of the various comments and concerns of Executive Directors for macroeconomic and financial stability, fiscal consolidation, unsustainable wage expenditure, and the restrictiveness of the trade regime, among others. A number of these are subjects of continuing discussion with the staffs of the IMF and the World Bank as the authorities also continue to address them in a prioritized manner. As I have stated earlier, all of these will be appropriately conveyed to the authorities.

I am, however, a bit worried by the call for including more conditionality. While I appreciate the need for a cautious approach and for adopting multiple scenarios, I fear advocating more conditionality might be leading us in the direction, even though inadvertently, of over burdening conditionality and making effective implementation by the authorities more difficult. Ms. Vtyurina says we add more conditionality "without the intent of burdening conditionality." But there is no way adding more conditionality would not result in burdening the conditionality profile. This Board not long ago approved the streamlining of conditionality, and there is broad agreement that doing so has reduced the number of our conditionality overall. I urge therefore, that we do not retract our steps on this and I strongly caution against any attempt to cross the bridge before we reach it. However, I have no problem with building in sufficient flexibility to allow for alternative or multiple scenarios to be examined or adopted.

A new PRGF-supported program and extensive technical assistance for Kenya, to help ameliorate the many of the downward risks posed by the limited human capacity and scarce financial resources will certainly facilitate and accelerate strong implementation of necessary adjustment and reforms. I would, therefore, like, once again, to re-assure the Board of my authorities' unwavering commitment and political will for the new reform agenda and I urge the Board to recognize the fact that tangible results can only be realized with time.

Ms. Vtyurina remarked that, while the Fund should not overburden the Kenyan authorities with conditionality, the current three-year program only contained conditionality until March 2004. It would be important, as other Directors had suggested, to examine ways of including and prioritizing additional conditionality in the program.

The Acting Chair (Ms. Krueger) confirmed that going forward there would be greater conditionality built into the program. It was a common practice to elaborate only on the conditionality for the first six months of the program.

The Acting Chair made the following summing up:

Executive Directors commended the authorities for having initiated bold reforms that will set the stage for reversing the weak performance of the economy over the past decade. They welcomed the authorities' Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC), which clearly sets out the authorities' broad objectives for improving economic performance and reducing poverty. They also welcomed the ongoing efforts to expand the ERSWEC into a full poverty reduction strategy based on a wide-scale participatory process, involving, inter alia, the private sector. They cautioned that considerable effort, and possibly additional time, will be required to put in place a well-articulated poverty reduction framework. A few Directors suggested that basing discussions on PRGF-supported programs on an assessment of alternative scenarios could be helpful to the authorities in strengthening domestic support for rapid reforms under the poverty reduction strategy.

Directors welcomed the high priority that the authorities are giving to strengthening governance and public institutions and accelerating structural reforms in their program for 2003/04–2005/06. They considered that faithful and sustained program implementation will be critical in order to encourage external donors to resume their support for poverty reduction and infrastructure investment and provide debt relief.

Directors endorsed the authorities' macroeconomic framework for 2003/04. Fiscal consolidation will be crucial to lower domestic debt and achieve debt sustainability. Directors stressed that sustained implementation of the program's structural reforms will be needed to address Kenya's macroeconomic vulnerabilities, improve the business climate, and enhance the role of the private sector in contributing to growth, thereby helping to achieve the ambitious income, employment, and poverty reduction objectives set out in the ERSWEC. Since much of the increase in spending on priority sectors depends on inflows from donors, the authorities were encouraged to develop plans to cut expenditure in ways that preserve priority spending in the event of shortfalls in donor financing.

Directors commended the government for placing the anticorruption strategy at the top of its policy agenda, embarking on a major strengthening of the anticorruption framework—including the passage of key governance legislation in May 2003—and strengthening the judiciary. They stressed the importance and urgency of putting in place fully functioning and effective institutions, supported by firm enforcement of laws and regulations, that can provide sustained implementation of the anticorruption strategy.

Directors called for a speedy rebuilding of the integrity and capacity of the Kenya Revenue Authority and a rationalization of the tax system to strengthen tax collection. They urged the authorities to implement a fundamental reform of the wage setting mechanism for civil servants and to continue with civil service reforms to reduce the share of the wage bill in total expenditure. They also called for a restructuring of the parastatal and financial sectors to address major sources of contingent liabilities.

Directors considered that strengthening expenditure management, including a move to a full Commitment Control System in the second half of 2003/04, will be essential for achieving the fiscal objectives of the authorities' program. Effective management of expenditure, including at the level of the local governments, will be crucial for preventing an accumulation of new arrears and ensuring that the desired restructuring of spending in favor of poverty reduction outlays and investment is achieved. Directors welcomed the authorities' efforts to improve the mechanisms for monitoring and tracking poverty reduction-related spending, as well as to strengthen the links between the annual budgets and the medium-term expenditure framework.

Directors welcomed the continued focus of monetary policy on maintaining low inflation so as to provide a stable environment for financial development. They endorsed the authorities' plan to reduce the level of excess reserves by year-end. Directors welcomed the authorities' intention to allow lending and deposit rates and banks' charges to be freely determined by banks to promote efficient financial intermediation. The wide spreads between banks' lending and deposit rates should be addressed by tackling the underlying structural problems in the banking system, including the high level of nonperforming loans, and the lack of effective security for bank lending.

Directors welcomed the measures to strengthen the financial system, and underlined the importance of steps to transfer bank regulatory functions from the Ministry of Finance to the Central Bank of Kenya, and restructure the National Bank of Kenya. They called on the authorities to establish a clear schedule to address nonperforming loans and proceed with divestment. They looked forward to the conclusions of the ongoing FSAP, which should help guide further financial reforms. They also urged the authorities to move ahead to enact new anti-money laundering legislation and to implement the remaining recommendations of the safeguards assessment.

Directors urged the authorities to persevere in their efforts to restructure the parastatal sector and to base an appropriately ambitious privatization program on a strong legal framework and transparent process. In this context, they welcomed their decision to set up a Privatization Commission, which should manage the divestiture program in a transparent manner.

Directors considered that actions to open trade, promote domestic competition, and preserve international competitiveness will be key elements of medium-term reforms. They accordingly welcomed the authorities' initial steps to lower Kenya's external tariffs in the context of the East African Community's customs protocol, and urged further trade reforms going forward, with the pace of reforms by Kenya and regional trading partners taking into account assessments of their social impact. Directors agreed that Kenya's flexible exchange rate system remains appropriate, but urged the authorities to continue to closely monitor exchange rate developments.

Directors encouraged the authorities to achieve further improvements in the data on national accounts, trade, prices, and poverty indicators in order to permit more effective surveillance and monitoring of ERSWEC outcomes.

Directors welcomed the financing assurances provided by Paris Club creditors with regard to Kenya's intention to request a new debt rescheduling.

The Executive Board took the following decision:

1. The Government of Kenya has requested a three-year arrangement under the Poverty Reduction and Growth Facility in a total amount equivalent to SDR 175 million.

2. The Fund determines that the PRSP Preparation Status Report submitted by Kenya set forth in EBD/03/107, 11/10/03 provides a sound basis for Fund concessional financial assistance.

3. The Fund approves the arrangement set forth in EBS/03/151, 11/10/03 and decides that Kenya may request the first disbursement under the arrangement, on the condition that the information provided by Kenya on the implementation of the measures referred to in Table 1 attached to the memorandum attached to the letter from the Minister of Finance dated September 22, 2003 as prior actions is accurate.

Decision No. 13132-(03/108), adopted
November 21, 2003

5. REPUBLIC OF MADAGASCAR—POVERTY REDUCTION STRATEGY PAPER AND JOINT STAFF ASSESSMENT

Documents: Poverty Reduction Strategy Paper (EBD/03/89, 10/9/03); Poverty Reduction Strategy Paper—Joint Staff Assessment (EBD/03/101, 10/30/03; and Sup. 1, 10/30/03)

Staff: Vaez-Zadeh, AFR; Fetherston, PDR

Length: 50 minutes

Mr. Ondo Mañe submitted the following statement:

The full PRSP that my Malagasy authorities are submitting to the Executive Board is the result of an extensive consultative process involving all stakeholders. It included civil society and the active participation of development partners and donors. It has also benefited from various thematic workshops organized at the regional and national levels. The document builds on the I-PRSP that was submitted to the Board in November 2000, and takes into consideration the recommendations made at that time.

A first full PRSP was prepared in 2001, but the severe political crisis of early 2002 caused the suspension of the process. The crisis worsened an already difficult economic and social situation, as real GDP contracted by 12.7 percent in 2002. It led to the emergence of a new category of poor people in urban areas, namely the large numbers of employees released by industries in the Export Processing Zone, which had closed down. The new government that took office in mid-2002, decided on a new orientation in government policies based on 3 strategic axes, namely, good governance, the promotion of broad-based economic growth to benefit the whole population, and the encouragement of human and social developments. The PRSP embodies the authorities' new orientation and strategy.

My Malagasy authorities consider the PRSP a well designed document that establishes the framework supporting the implementation of an effective operational poverty reduction strategy. Consistent with the Millennium Development Goals (MDGs), the PRSP sets as principal objective the reduction of poverty by half over the next ten years, from the current level of 70 percent of the population to 35 percent by 2013. It gives detailed descriptions of poverty in Madagascar and describes the measures to be implemented in the different sectors of the economy, the priorities and sequencing of the measures, the mechanisms to monitor and evaluate its implementation, their general costing and the expected outcomes. It also outlines the macroeconomic objectives that have to be met to ensure achievement of the MDGs. The strategy was presented to a Donors' Meeting (Friends of Madagascar) in Paris in July 2002. It was endorsed by donors who pledged their full support to the efforts of the authorities. At the second meeting in October 2003, donors expressed their satisfaction with the economic reforms undertaken and the management of the first installments of funds.

The PRSP gives a central role to governance issues. The authorities are of the view that improving governance can make a very significant contribution to the reduction of poverty, and to the development of the economy. Steps have already been taken to improve and make the budgetary process more transparent, and to strengthen customs administration and the judicial system. An anti-corruption unit has been set up. These efforts will be strengthened over the medium term.

On the issue of poverty, as the document shows, more than 80 percent of the poor in Madagascar live in rural areas, and they depend mostly on agriculture, especially the production of rice. Therefore, the PRSP places emphasis on the development of the agricultural sector, while also giving consideration to environmental factors. Various measures have recently been taken, such as the rehabilitation of the irrigation systems in many villages, helping the farmers to obtain fertilizers, the provision of technical assistance as well as the improvement in land communications so as to enable the farmers to take their products to markets. These are only the first steps, and as the document describes, there is a broad strategy to develop the agricultural sector which can boost significantly the growth rate of the economy. Higher and sustained growth in the agricultural sector will be important to ensure a fair distribution of the benefits of growth.

The PRSP stresses infrastructural development as the basis for economic development and poverty reduction. The document analyzes past shortcomings of policies and identifies key reforms that are needed. In particular, it identifies improvements in public transportation as of fundamental importance in order to develop domestic trade, integrate farmers into the economy, and enable the population to have access to education and health facilities. The objective is to rehabilitate and build 14,000 Kilometers of roads over the next decade. Already with the assistance obtained, more than

3,000 kms of main roads, and over 1,700 kms of secondary roads have been repaired.

A major emphasis is being placed on the development of a dynamic private sector. Incentives provided up to now have been instrumental in attracting foreign investors, and in the setting up of factories in Madagascar. This is helping to create tens of thousands of new employment opportunities. The PRSP calls for broad tax and other legal and land reforms which should strengthen the development of the private sector. This effort is being supplemented by renewed actions to reform the public enterprise sector where several enterprises have been put up for sale or are being readied for privatization. The policy measures envisaged are also aimed at ensuring that private sector investment goes to rural areas as well to ensure that growth is better distributed.

On social policies, the PRSP has an extensive program, with clear sets of objectives. In the area of education, for example, one objective is to ensure that by 2015 all children complete primary education, compared to 33 percent presently. Already, this year more than 150 classrooms have been built, 4000 teachers have been recruited, and children enrolling in primary schools have been provided with "school kits" containing books and school supplies. The latter measure was a first and has already led to a larger number of children starting primary schools; it will also ensure that children do not drop out for lack of school supplies. Similarly, steps have been taken in the health sector to increase the number of rural clinics and to help improve the nutrition of mothers and infants. Efforts are underway to improve the supply of drinking water and other basic health needs. Much more will be done over the coming years, as detailed in the PRSP.

The PRSP develops alternative macroeconomic scenarios, linking poverty reduction to various growth paths. As was recommended by the staff in the last JSA, the PRSP includes two macroeconomic scenarios, a low-growth and a high-growth scenario. My authorities view the high-growth scenario as the one most appropriate to ensure the achievement of the MDGs. While ambitious, it is also realistic and takes into consideration the wide range of measures that will be implemented in all sectors of the economy, as well as higher investment. For example the investment need for 2003 was fully subscribed, and is contributing to the achievement of a rate of economic growth of about 8 percent, compared to 6 percent that had been projected. Progress is also being made in the achievement of the 2004 investment target. The authorities are working closely with the private sector to help remove constraint to private sector investment. A one-stop office has been created to speed up the administrative process for investors. Responses up to now have been positive. The higher growth rate takes into consideration the high potential for growth in Madagascar, as the country is well endowed with natural resources in agriculture, fishing, mining, tourism, etc. Nevertheless, my authorities recognize that serious risks remain in the implementation of the PRSP, but they are confident that with the policies they are following in cooperation with the Fund and the World Bank and with continued timely financial and technical support from the international community, the high growth objective is achievable. They also view the policies they are implementing as strengthening the credibility of the government vis-à-vis the private sector and donors.

In conclusion, I would like to say that my Malagasy authorities are fully committed to the PRSP. They have made it their economic document, and it is receiving a very high visibility in the country. The document was presented to the National Assembly where it has been discussed and approved. The staff has assessed the strengths and the weaknesses of the PRSP. My authorities would like to reiterate that they welcome the staff's assessments and will give them careful considerations. The authorities consider the PRSP as a dynamic process. It will be regularly updated, and it will take into consideration the experience gained as well as the recommendations of all development partners. The Secretary has also received from the authorities the consent to publication of the JSA.

Mr. Misra submitted the following statement:

Key Points

Madagascar's PRSP is a consistent and credible poverty reduction strategy, and is a major instrument for poverty alleviation in the country.

The consultation process has been extensive and a high level of ownership of the PRSP exists.

For efficient absorption of aid flows, significant deficiencies in service delivery and bottlenecks of limited implementation capacity have to be overcome.

The authorities' commitment to increased revenue mobilization has to be higher.

We thank the staff for a comprehensive set of papers. We also thank Mr.Ondo Mañe for his insightful preliminary statement.

This chair has consistently supported the interim poverty reduction strategy (I-PRSP) for Madagascar discussed in the Board of the Fund since November 2000. We also supported the comprehensive program for a three-year arrangement under the PRGF in December 2001. In our remarks, we had observed in 2001 that the PRSP is a dynamic document, which can be improved upon subsequently. We are happy to note that significant changes have been made to the draft PRSP by the new Government, including the elevation of governance reforms to the core of the strategy and building sector strategies around work program agreements between ministries and the president. We are also happy to note that some of the staff's concerns regarding a clearer road map of the participatory process and alternative assumptions on macro-economic growth scenarios have been developed.

We commend the authorities for strengthening the consultation process. This was a major weakness with the earlier document, and only 4 percent of the members who attended the consultation process in 2000 were parliamentarians and mayors. Besides, the role of the democratically elected institutions in preparation of the draft vis-à-vis other participants was not clear. We are happy to note that the PRSP has been discussed with all groups of Malagasay society, private and non-governmental organizations and regional workshops have been held in each of the six provinces of the nation. We also note that the PRSP has been presented to the National Assembly in 2003, where the document was discussed and approved. As a result of these extensive consultations, we believe that the level of ownership of the PRSP document is high. We also commend the authorities for incorporating community preferences and listing the vulnerabilities of the population in the PRSP. Considering the high degree of transparency, we recommend that the authorities consider producing a poverty status report on a semi-annual basis to be presented to parliament.

The poverty levels in Madagascar have changed marginally since the structural reforms were initiated in 1993. In fact, from 1993-99, the incidence and depth of poverty have increased and in spite of the specific schemes being designed to address the rural landless poor, the trend has only been marginally arrested. It appears that the impact of the HIPC Initiative, which reached the decision point in 2000 and PRGF-supported programs since 2001 and the benefits of growth and structural reforms in the macroeconomic sector have not trickled down to the Malagasay society, especially the rural society We note that of the two macroeconomic scenarios projected, the scenario with external financing indicates, high growth rates of 8-10 percent can be achieved until 2015. We agree with the staff's view that, for efficient absorption of higher aid flows, the significant deficiencies in service delivery and bottlenecks of limited implementation capacity will have to be overcome. For this, the authorities would be advised to effectively implement important governance reforms in public finance management and capacity building under the five-pronged approach recommended by the staff, namely, (a) improved service delivery for both private sector development and poverty reduction, (b) overcoming institutional constraints of the agricultural sector, (c) enhancing private sector's access to credit, (d) rehabilitation and privatization of state-owned enterprises at a timely pace, and (e) additional sources of financing in cases of shortfalls in government revenues. We note the staff projections of intermediate growth rates of 6 percent in the medium term and the proposed conditionality for the first annual review. Considering the frequent slippages in the poverty reduction efforts in the past and limited successes achieved, we support the conditionality for the agricultural sector and governance reforms being proposed by the staff for the first annual review.

We agree with the staff's view that the PRSP document only discusses the macroeconomic framework in a limited manner. It would be useful to present a coherent overall view on areas of our traditional mandate and responsibility in subsequent Board documents.

On the fiscal policy side, we agree with the staff's view that domestic revenues in Madagascar are low and significant efforts are needed in the medium term to finance the poverty reduction strategy. While we did appreciate the authorities' need for extending tax incentives in 2002 to stimulate investment, we feel that further proliferation of the ad hoc tax and customs duty exemptions do not support the objective of reforms. We support the staff recommendation that the PRSP progress report should indicate the authorities' commitment to reforming excise duties, external tariff, and income tax, and improving tax and customs administration.

We also support the staff's view that costing of the proposed actions is one of the weak points of the strategy. We agree that, in the light of irregular expenditures and transfers witnessed in the previous years (only 6 percent of the road maintenance funds were used in 2001), the authorities would be well advised to develop a preliminary Medium-Term Expenditure Framework so as to enable ministries to cope up with the planned strong expansion of public investment. We also support the staff's proposal that the normal budgetary process should include programming of investments financed through savings from the HIPC Initiative, as this would avoid underutilization of these resources.

We agree with the staff's proposal that the government conduct intensive reviews of the proposed priority indicators and their targets in the first year of implementation and add a monitoring indicator on private investment. This issue was raised in the past too, and we had consistently felt that the impact of the program should be measurable through changes in social indicators. We also support the proposal for integrating the different indicators and objectives derived from policy actions and sector investment programs with the full costing details.

Governance reforms have a central role in the fight against poverty. The PRSP outlines the efforts in public affairs management that would be required to enhance the access of administration to a larger share of the population, bring about transparency and accountability, increase judicial effectiveness, and create an environment conducive to the economic and social development of the communes. We agree with the staff's view that considerable technical assistance would be needed for successful implementation of governance reforms in the PRSP. We welcome the constitution of the private/ public committee for implementing reforms in the customs and tax departments.

We agree with the three-pronged approach to implementing structural policies for growth and investment. For agriculture growth of 5 percent in the coming years, farmers have to be integrated into the market economy through better road network. Commitment to public-private partnerships in management of key public enterprises and improving the environment for reforms in tax and tariff policies, land laws, and better governance are key issues for implementation of structural policies. We are happy to note from Mr. Ondo Mañe's statement that a one-stop office has been created to speed up administrative processes for investors and that the response to this initiative has been positive. Tenurial rights are an essential feature of land reforms and the authorities' efforts to establish clear land titles would be a major step in this direction, which, in turn, would result in agrarian reform.

As the staff has rightly pointed out, the rural development section of the PRSP does not delve on the reasons for past failures. Decadal failures in substantial poverty reduction measures normally constitute vital analysis for future directions for large scale investment expansion, and complementary institutional changes. We also agree that the section on raising agricultural productivity remains unclear. The PRSP also largely fails to establish the links between the identified objectives, actions to be taken and expected results. This is a vital ingredient missing from the PRSP and could be taken up subsequently.

We welcome the overarching long-term objective of the PRSP education strategy. Universal primary education is in line with the education for all initiative and the Millennium Development Goals.

We agree with the staff's views on the risks that could undermine the successful implementation of the strategy, especially with regard to under-financing. We believe that, where necessary, the international community would come to the aid of Madagascar in implementing the PRSP. Madagascar's PRSP is a credible poverty reduction strategy and is a major accomplishment. We support the proposed decision in this regard.

We wish the authorities all success in their policy endeavors in implementing the PRSP.

Mr. Duquesne submitted the following statement:

We welcome this opportunity to discuss the PRSP and the Joint Staff Assessment (JSA). We first want to commend the authorities for issuing this comprehensive document within a short time frame, which attests to their commitment to put the poverty reduction in Madagascar at the top of their agenda. The new Government was successful in spelling out its own poverty reduction strategy while building on the I-PRSP of 2000 and thereby maintaining the balance between the long-term character of such a strategy and the new priorities. We also want to commend managements and the staffs of the Bank and the Fund for their comprehensive and well balanced analysis. We agree that the PRSP represents a sound policy framework and provides an adequate basis for Bank and Fund concessional assistance and for debt relief. While we broadly concur with the analyses and recommendations made in the JSA on the PRSP, we would like to make the following comments:

The Participatory Process

The inclusive and intensive participatory process of the Malagasy society is clearly one of the major strengths of the PRSP. We commend the authorities for having made considerable efforts in organizing thematic workshops on the national and decentralized levels as well as for ensuring the participation of the National Assembly. We also welcome the participatory approach being adopted with regard to the monitoring framework through the organization of participatory workshops twice a year.

Poverty Diagnostic

As pointed out in the JSA, the Government of Madagascar has to be commended for having included a detailed description of poverty developments and the profile of the poor in the PRSP. However, we concur with staff that it is necessary to further analyze the impact of the economic growth policies on poverty reduction and to include the analytic findings in the PRSP progress report. Likewise, we believe that two other aspects in particular should be addressed in the PRSP where there is a gap between the quality of the analysis and the identification of the respective actions which have to be taken. First, while we note that on the one hand the gender dimension is well addressed in the analysis, on the other hand the strategy fails in making the adequate gender related differentiations by sectors and actions. In this context, we concur with staff that especially the enforcement of gender responsive laws is of crucial importance. Second the analysis highlights the linkages between the high population growth and the development of poverty. However, the strategy neither refers to any specific population policy to be pursued by the government nor does the Action Plan 2004 allocate resources to it.

Macroeconomic Framework and Costing of the Strategy

The macroeconomic framework and policies for 2003 contained in the PRGF-supported program and reflected in the CAS falls between the high and low-growth scenario in the PRSP, with an objective of GDP growth of 6 percent. With an expected growth of 9.6 percent and low inflation in 2003, the authorities managed to quick start the economic development of the country especially in the agricultural sector. While we welcome these good performances, we believe that the achievement of the high growth rate scenario in the medium term may be constrained by the limited absorption capacity of the economy.

We encourage the authorities to continue to conduct sound monetary and fiscal policies for establishing confidence in a stable macroeconomic environment and attracting investment, and to pursue their efforts to implement their ambitious structural reform agenda.

Governance

The emphasis in the PRSP on governance, especially on efficiency, transparency, and accountability in the use of public resources, is particularly welcome and represents one of the greatest challenges facing the authorities. The fight against corruption and improved fiscal and public expenditure management are crucial to avoid undermining budgetary control and to speed up budget implementation in priority areas. We fully agree on the proposed actions to spell out the strategy for legal and judicial reform and further improve public expenditure management as an effective vehicle for poverty reduction. We also welcome that the PRSP emphasizes the importance of effective decentralization to create ownership of development for the local population. The strategy also reflects the decentralization process in the different priority sectors, for instance with regard to production pools in rural areas and the regional adjustment of vocational training. However, it remains unclear how the prioritization in implementing the sectoral action plans will be carried out at the regional and local levels and which role is to be attributed to the provinces and communes and their regional and local development plans.

Priority Sectors and Action Plans

The translation of the clear and well argued strategy into actions plans for line ministries structured in short- and long-term programs' output and detailed indicators is commendable. However, prioritizing and costing of the action plan and its translation into a budget has still to be worked out by the authorities to assess the expenditures needed to achieve the ambitious targets set out in the PRSP, taking into account a progressive approach relying on the existing and future capacities of implementation. We also agree with the JSA that further harmonization of the different targets and actions related to the strategic focuses and of the indicators is needed.

Agriculture Development and eEnvironment

We believe that the PRSP correctly builds on environmentally sustainable rural development which is of the utmost importance to fight poverty in Madagascar. However, as pointed out in the JSA, the implementation of a strategic plan aimed at raising agricultural productivity could benefit from a thorough analysis of lessons learned from previous experiences, in particular with regard to the mechanization in agriculture, agro financing and use of fertilizer as well as rice production in irrigated perimeters where the private sector can play an active role. Furthermore, the environmental protection strategy does not sufficiently elaborate on the relation between rural development and the preservation of natural resources. The PRSP progress report should therefore outline incentive policies to promote the environmentally sustainable use of natural resources. One of the main challenges in the protection of the environment will be the successful fight against corruption particularly in the forest sector. We therefore welcome the actions taken by the Government and are looking forward to learning about the impact of these actions in the PRSP progress report.

To conclude, we commend once again the authorities for issuing this fundamental document, which will pave the way for the long-term development of the country, and we wish the authorities every success in the implementation of the PRSP with the support of their development partners.

Mr. O'Loghlin and Ms. Cunningham submitted the following statement:

Key Points

- This Chair agrees that the Poverty Reduction Strategy Paper for Madagascar provides a sound basis for Fund concessional financial assistance.

- We particularly welcome the approach of grounding the PRSP on progress towards the Millennium Development Goals.

- Judicious management of expectations will help to preserve wide-ranging ownership. A growth rate much above 6 percent seems optimistic. In this context, the first review of the PRSP should assess the degree to which conditions for growth have been improved.

- Significant revenue efforts are needed in the medium term to underpin the financing of the poverty reduction strategy.

- Improving governance can make a very significant contribution to the reduction of poverty, and to the development of the economy.

This Chair agrees that the Fund should determine that the Poverty Reduction Strategy Paper for Madagascar provides a sound basis for Fund concessional financial assistance.

We particularly welcome the approach adopted by the authorities of grounding the PRSP on progress towards the Millennium Development Goals. Whatever the deficiencies in the PRSP in linking those desired outcomes with sectoral or other programs or initiatives, or in costing programs or assessing probable outcomes in terms of the MDG measures, goals related to the key aspects of human welfare—and its sustainable improvement—are always the appropriate focus for public planning.

Like the staff, we are satisfied that, while the discussion of the macroeconomic framework in the PRSP is limited, the framework is generally sound. However, reviewing the PRSP's two macroeconomic scenarios—a welcome response to the recommendations of the last JSA—we share the staff's skepticism about the capacity to realize the higher-growth outcome. While we agree with Mr. Ondo Mañe that its realization would better underpin the achievement of the Millennium Development Goals, the 6 percent growth rate suggested by the staff seems to be a more realistic assessment of what may prove possible.

The authorities are to be congratulated for the wide-ranging steps they have taken to ensure that the PRSP is underpinned by a high degree of ownership and has a high degree of public visibility. Sustaining that degree of ownership over the period ahead will be important to the successful implementation of the strategy. In this context we believe, like the staff, that the first review of the PRSP should assess the degree to which conditions for growth have been improved, and against that background discuss how a lower growth outcome (than the high-growth scenario) would impact priorities among fiscal choices—and progress towards the strategy's goals. Judicious management of expectations will help to preserve wide-ranging ownership.

Significant revenue efforts are needed in the medium term to underpin the financing of the poverty reduction strategy, given that domestic revenues are little more than 10 percent of GDP at present. We welcome the targeted increase in revenue over the medium term and the steps taken to improve customs administration, but would encourage the authorities to commit to reversing ad hoc tax and customs duty exemptions—which erode the tax base and distort economic incentives, thus do not support the PRSP's economic and social objectives.

We fully agree with Mr. Ondo Mañe's comment that improving governance can make a very significant contribution to the reduction of poverty, and to the development of the economy. We believe that it is crucial to develop the management of public spending in ways that will ensure strong linkage from results desired to actions taken. The sounder budgetary planning, execution, and monitoring are, the more effective programs can be in meeting key objectives. Accordingly, we welcome his assurance that steps have been taken to improve the budgetary process and make it more transparent. We agree with the staff that past policies and projects should be analyzed in terms of their effects on the poor in society, as a key contribution to strengthening the effectiveness of the PRSP in tackling Malagasy poverty.

From the standpoint of underpinning an improved growth performance, we welcome the steps taken to strengthen the judicial system and, given the debilitating effects of actual or perceived corruption on confidence generally, the establishment of the anti-corruption unit which Mr. Ondo Mañe also notes. We feel sure that the authorities' plans to strengthen these efforts over the medium term will prove positive for growth into the medium term and beyond. Building confidence about the thrust of the broad canvas of national policy is important at any time, but all the more so in the aftermath of political crises.

But it is equally important that Madagascar sustain confidence in its economic potential. At this juncture, it must preserve competitiveness in exports and rebuild its market share. The increased priority for public investment foreshadowed in the PRSP is welcome in this context—in particular insofar as it will aid the development of the transport sector and integrate the rural community into the market economy. Foreign investment in Madagascar's cotton industry could provide an important boost for that industry. In addition, private participation in the sugar company, SIRAMA and in the electricity and water utility, JIRAWA could also assist in expanding growth.

In concluding, we would again stress how much we welcome the approach of clearly grounding the PRSP on progress towards the Millennium Development Goals. We wish the authorities every success in their endeavors to deliver on those goals for their people.

Mr. Usman submitted the following statement:

We thank the staff for a comprehensive set of papers and Mr. Ondo Mañe for his helpful statement.

We welcome the new Government's determined effort to restore economic and political stability and their working closely with the Fund and the Bank to develop a strong adjustment programme, consistent with the PRSP, and with sustainable growth and reduction of poverty. The PRSP sets as principal objective the reduction of poverty by half over the next ten years consistent with the Millennium Development Goals (MDGs) and spells out the measures to be implemented in the different sectors of the economy appropriately prioritized and sequenced. We support the authorities' main thrust of the strategy, which ensures coherence between the PRSP and sector development plans. Given the extensive consultative process undertaken, we believe that with appropriate level of Financial and technical assistance from the international community coupled with the strong political will and commitment of the authorities, the objective of the strategy are achievable.

We commend the authorities for strengthening the much needed consultative process and completing the full PRSP in spite of unfavorable exogenous conditions and other challenges.

Governmental reforms have a central role in the fight against poverty. The PRSP outlines the efforts in public affairs management that would be required to enhance the access to government by a larger share of the population, for increased transparency and accountability and judicial effectiveness. We agree with the staff that technical assistance would be needed to facilitate successful implementation of governance reforms in the PRSP.

We concur with the staff also that efficient absorption of higher aid flows, the significant deficiencies in service delivery, and problems associated with implementation capacity will be experienced in the short term. We therefore urge the authorities to implement important governance reforms in public finance management and capacity building under the five-pronged approach recommended by the staff.

On the fiscal policy, we note that domestic revenues in Madagascar are low and significant efforts are needed in the medium term to finance the poverty reduction strategy. We commend the authorities for extending tax incentives in 2002 to stimulate investment as further proliferation of the ad hoc tax and customs duty exemptions do not support the objective of reforms. We agree with the staff recommendation that the PRSP progress report should indicate the authorities' commitment to reforming duties, external tarriff, and income tax administration.

We support the strategy despite the risks that could undermine its successful implementation, especially on the side of financing. We urge the international community to support Madagascar to implement the PRSP strategy.

We therefore, support the proposed decision and we wish the authorities success in their endeavors.

Mr. Cobos made the following statement:

The poverty reduction document (PRSP) presented for analysis by the new authorities represents a major step forward in the efforts to pursue a stable and ambitious growth path in partnership with the private sector. This program includes comprehensive structural reforms, and the implementation of strategies for full development of the productive sectors and the reduction of poverty in half within the next 10 years.

The PRSP document responds to most of the JSA's 2000 observations, provides better poverty diagnosis and adequate sector plans, and improves on the linkage between growth and poverty reduction. Nonetheless, efforts are still needed in public investment costing, basic service delivery expenditures, analysis of impact on the poor of past strategies, and risk assessment. Implementation capacity is a major challenge, particularly given the expected higher levels of aid flow. The technical secretariat (STA) undertook vast consultations with stakeholders through participation in specific thematic working groups and workshops nationwide. The poverty diagnosis is based on several household surveys and studies supported by donors and international organizations. In addition, the PRSP has been recently approved by the national assembly and has been widely distributed. These conditions attest to a high ownership and commitment by the new authorities.

The authorities are pursuing structural reforms and striving for macroeconomic stability with the support of the Fund's PRGF-supported program, IDA's interim country assistance, and grants from donors. It is expected that the first annual review of the PRSP will touch on various specific issues to improve the program's effectiveness and reliability. The staff suggests revisiting the high growth scenario and its impact on poverty, reviewing the tax and exemptions structure, and improving tax and customs administration. The report should consider, among others, technical assistance needed to enhance reforms in the fiscal area, the judiciary, budget planning, and the monitoring and control of expenditure in key sectors.

We are encouraged by the approach to open up the opportunity for the private sector to become a major participant in the economic endeavors of Madagascar. We note that effort is directed to improve the business environment by re-examining the legal framework, reforming land laws, and promoting public-private partnerships. To this end, we note the PRSP's approach to allow concessions and management contracts, primarily in the transport sector. Steps are envisaged to attract FDI to the cotton sector, the sugar industry, and water and electricity utilities. A major role is expected to be played by agricultural diversification, though a strategy of achieving a minimum economic infrastructure for rural development.

This country has made strenuous efforts to provide larger resources to key sectors, and the PRSP portrays the strategy to increase delivery of health and education benefits to the poor. Still, illiteracy affects more than 50 percent of the population, school repetition rate persists at about 30 percent, and about 33 percent of children do not finish basic education. On health issues, we note the low life expectancy rate, deteriorated mortality indicators, limited access to water-supply and sanitation, and low vaccination coverage. The PRSP addresses the need to increase facilities and personnel in health and education, and, as suggested by the staff, call for a review of sectoral indicators.

We concur with staff that the PRSP proposes appropriate strategies, and pursues reforms that should generate adequate and sustainable growth that would sustain substantial reductions in poverty levels. We believe it meets the requirements for concessional assistance and look forward to the first annual report on its implementation.

Mr. Jang made the following statement:

After experiencing a deep economic and political crisis, it is encouraging to note that the new government has been making good progress on economic revitalization and poverty reduction. Their concerted efforts seem to be embodied in the completion of the full PRSP. While the full PRSP has some weaknesses in certain areas, as the staff point out, we are pleased to learn that the preparation of the PRSP was based on broad consultation with extensive public participation to enhance national ownership. Overall, we agree that the PRSP provides an adequate basis for poverty reduction and represents a sound policy framework for concessional assistance. Nonetheless, we believe that the PRSP needs to further elaborate its strategy and macroeconomic framework so that it can provide a window of opportunity to make progress towards poverty reduction and sustainable growth. Since we broadly agree with the Joint Staff Assessment, we wish to raise a few points for emphasis.

First, the authorities should be commended for analyzing the poverty profile well and including detailed descriptions of poverty development in the PRSP. As noted in the paper, reducing the poverty rate in rural areas should be a top priority to enable sustainable growth and to achieve the Millennium Development Goals in a situation where 85 percent of the poor live in the rural environment and are largely dependent on agriculture. It is reassuring to note that the authorities have implemented various measures to increase agricultural productivity and recognize the importance of development in the agricultural sector to boost the growth rate, as noted in Mr. Ondo Mañe's statement. However, we share the staff view that it is useful to analyze past developments, why they failed, and how they have impacted on the rural areas, as the rural poverty rate has not decreased despite macroeconomic growth. Thorough analysis of past experiences will help to enhance the effectiveness of policy implementation for the poor and to use the limited resources efficiently, given the expected massive investment in this sector.

We also believe that it is equally important for the authorities to develop an environmental protection strategy to preserve natural resources. In this regard, we join the staff in encouraging the authorities to outline incentive policies to limit environmental degradation.

Second, while we commend the authorities' effort in developing an alternative scenario as recommended in the last Joint Staff Assessment, we share the staff's view that the high growth scenario may not be achieved given limited implementation capacity. In this regard, it is sensible for the authorities to revisit the high growth scenario in the first PRSP progress report.

Third, we welcome the authorities' intention to press ahead with governance reforms. While these reforms take time to show results, they should be implemented without delay, as it is important for the authorities to gain investors' confidence and the continued support of the international community, which are necessary for achieving the PRSP goals. In this regard, it is reassuring that the authorities have already implemented reforms in the areas of budgetary process, customs administration, and anti-corruption. However, we concur with the staff that the authorities should develop a detailed plan as to how the objectives are to be attained.

Finally, we cannot overemphasize the importance of implementing appropriate social policies to reduce poverty. The emphasis on the education and the health strategy in the PRSP is welcome. We believe the decentralization of the educational system should enhance its effectiveness. In this regard, it is important to allocate relevant budgetary resources to school districts in a timely manner, and we join the staff in encouraging the authorities to add budgetary monitoring indicators to evaluate the effectiveness of decentralization. In addition, population policy should be developed given the importance of its impact on health and education.

With these remarks, we support the proposed decision and wish the authorities continued success in the implementation of the PRSP.

Mr. Baukol made the following statement:

We concur with the Joint Staff Assessment that the PRSP provides a sound basis for development assistance. The PRSP makes progress towards centering Madagascar's development strategy on key policy and economic objectives that can create real differences in the short term and set the stage for continued progress in the long term. We welcome the focus in the PRSP on governance, economic growth, and investing in people, as described in Mr. Ondo Mañe's statement. In addition, like Mr. Cobos, we commend the authorities on developing a participatory process and producing a PRSP that looks to the private sector as the primary engine of growth. Given the importance of the private sector in the strategy, it would have been helpful to know more specifically about the participation levels and concerns of the private sector. Perhaps the staff could provide further elaboration as to the reactions of the private sector to the PRSP.

The PRSP presents a thorough analysis of the multiple dimensions and determinants of poverty in Madagascar. We agree with the JSA that more should be done to cost out the program, and given that the effectiveness of government spending is more important than the level of government spending, we welcome the plans for the World Bank to conduct a Public Expenditure Review.

Clearly, an improved investment climate will be critical in unleashing the potential for private sector growth. We welcome the intention to develop a strategy to combat corruption. On these issues, I agree with Mr. Duquesne and Mr. Jang.

The PRSP identifies a number of primary growth sectors, including tourism and manufacturing. Mr. Jang, however, has noted that 85 percent of the poor live in rural areas and depend on agriculture as their primary source of income. We are therefore concerned that agriculture is not included as one of the primary sectors in the sectors targeted for higher growth. The PRSP focuses on agriculture in the context of poverty reduction, but it should not be excluded as a major growth area. Both the JSA and the World Bank's CAS discuss the failures of past strategies to successfully engender poverty reduction in rural areas, despite previous growth-oriented strategies. In our view, rural farmers should be viewed as important members of the private sector, poised to make substantial contributions to growth. Despite this concern, we are pleased that the agriculture policy focuses on decreasing the isolation of the rural farmer by disseminating market information and developing rural roads.

We welcome the recognition of the link between rural poverty and environmental degradation, and the authorities' conclusion that "environmental management cannot be treated separately from development." While we appreciate the quantitative benchmarks for environmental conservation, we concur with the staff that the authorities should address the institutional framework and past shortcomings in the first progress report.

Turning to SMEs, the development of a strategy to facilitate access to financing for SMEs is an important issue, but it is not clear how the strategy will be implemented. Do the authorities intend to enact this program with directed credit? How does the plan overcome previous barriers to providing financing to SMEs? It is not clear what kind of credit institutions are envisaged and how they will be backed financially.

We welcome the inclusion of various economic growth scenarios in the PRSP. These scenarios will help the authorities prioritize their development goals under a variety of economic conditions, and inclusion of main outcomes of each strategic focus demonstrates how the authorities expect to achieve the goals, and it offers measurable results. Given that the authorities plan to evaluate the PRSP annually, these outcomes will provide a useful starting point to evaluate the opportunities and weaknesses of the strategy going forward.

Mr. Vogel made the following statement:

We would like to thank the staff for a well-written report. Since we agree with the thrust of the staff appraisal, I will limit my intervention to a few comments for emphasis.

We commend the authorities for the PRSP that, as the staff notes, is a major accomplishment that integrates existing sector development programs. This PRSP has several major strengths that we consider critical for its success. We attach special importance to the role that consensus plays in the decision-making process. In this regard, we welcome the fact that PRSP preparation includes substantial consultations with all groups of the Malagasy society and the wide distribution of the document within the country. Meanwhile, we are encouraged by a very high degree of ownership that would help to reconcile the comprehensiveness of the document with the need to identify strategic priorities. In that vein, the clarity and the logic of the strategy are very important. Regarding the poverty diagnostic, we consider that knowing the community preferences may be useful, even though it should not replace government leadership.

In general, we consider that it is crucial to pay careful attention to the consistency of the macroeconomic framework and, in this regard, we are concerned by the staff's skepticism that the high growth scenario of the PRSP can be attained. Therefore, we share the staff's recommendation that the high growth scenario be examined in detail in the first annual PRSP report.

We very much welcome the central role that Madagascar's PRSP assigns to governance reforms in the fight against poverty. In this area, we have to say that the last report of Transparency International on Corruption Perception has shown some progress. While Madagascar ranked 98 out of 102 countries in the 2002 report, with a score of 1.7, it ranked 88 among 133 countries in 2003, with a score of 2.6. Notwithstanding this improvement, the low level of the score clearly shows that much remains to be done in this area. Progress in this area is essential to attract new FDI flows, and accomplish a strong and sustainable growth that could be enjoyed by a large share of the population.

One of the most significant ways to mitigate and alleviate poverty conditions is through education. While we welcome the PRSP education strategy aimed at achieving universal primary education and ensuring that all children complete the primary cycle, we take note of the staff's reservation on the managerial capacity necessary to meet the goals and the specific performance indicators.

Consequently, we concur with the staff in considering this PRSP a credible poverty reduction strategy that provides a sound basis for Fund and IDA concessional assistance. We wish the authorities every success in their future endeavors.

Mr. Srinivas made the following additional statement:

A preliminary statement has been issued from our chair, but my authorities would like to raise some more issues.

While we do support Madagascar's PRSP as a credible poverty reduction strategy and as a major instrument for poverty alleviation in the country, we wish to raise some additional issues regarding the experience of poverty reduction strategies of Madagascar. Considering the marginal changes in high poverty levels over the last decade in Madagascar, despite interventions by the Fund and Bank and the donor community, we feel more assistance is necessary along with technical assistance from the Fund. In 1996, this Board approved the enhanced structural adjustment facility for Madagascar, amounting to SDR 2651 million. In 1999, this Board approved Madagascar's request for the second annual arrangement under the Enhanced Structural Adjustment Facility and its request for extension of the commitment period on the basis of good macroeconomic performance in the preceding years. The cost for financing the program was SDR 1751.8 million. In the year 2000 the Board considered the interim poverty reduction strategy aimed to cover 70 percent of the population living in poverty, projecting a high baseline growth rate of 7 percent. The donor community of Paris Club donors assisted by rescheduling the country's external debt. The African Development Bank supported the PRSP process with a special facility under its structural adjustment loan geared to strengthening the participatory process.

In 2001 a team of Executive Directors visited Madagascar, Rwanda, and Mauritania, and observed that the approach to fighting poverty based on complementarity between economic growth and social improvements is not fully understood, and more effort should be dedicated to explaining how the fight against poverty can be carried out in an integrated way. The Joint Staff Assessment of December 2002 suggested that Madagascar's growth strategy needs to be examined in the light of a recent study. The high overall economic growth in Madagascar from 1997 to 2001 led to a noticeable decline in urban poverty. Rural poverty, on the other hand, remained very high, and had even increased due to lack of progress in raising agricultural productivity. Further, the growth of textiles, mining, fishing and tourism did not spread welfare to poor areas which lacked basic infrastructure and access to markets. The study also said that the poverty impact of growth would need to be raised significantly if the long-term poverty targets are to be achieved.

This Board needs to ask itself why is it the case that the Fund and Bank programs, while stabilizing the macroeconomic situation, have not had a substantial impact on poverty reduction strategies. The Joint Staff Assessment of 2003 mentions that efforts for raising agriculture productivity remain unclear. However, in the previous years, a lot of work has been done in the agrarian sector, including development of an appropriate land holding policy, security of land tenures, microfinance for farmers, water user associations for irrigation, and technical assistance for agricultural extension. What has been the impact on self-employment and what are the employment opportunities in the agriculture sector in the past interventions? Is advanced technical assistance in agricultural extension and research centers for seed multiplication, certification, and pesticide use available to the Malagasy farming community following our interventions? Has the dismantling of the cotton and sugar monopolies proved beneficial to the community by way of increased procurement prices? We invite staff comments.

Mr. Al-Nassar made the following statement:

I welcome the completion of Madagascar's comprehensive and well-focused Poverty Reduction Strategy Paper (PRSP). This PRSP represents a major effort based on an extensive dialogue and broad participation. It covers a lot of ground and makes substantial inroads in understanding the poverty problem. Also, as indicated by the staff, the targets and objectives spelled out in the paper are consistent with the Millennium Development Goals (MDGs). I, therefore, agree with the joint staff assessment that the PRSP is a credible poverty reduction strategy and provides a sound basis for concessional assistance from the Fund.

The challenge now is to press the implementation process. Clearly, the authorities' efforts deserve continued Fund cooperation, including provision of the needed technical assistance. In this connection, I broadly share the areas that the staff has identified for further attention.

Specifically, high priority should be given to capacity building in view of the country's limited project implementation capacity. It is also important to integrate the PRSP goals into the medium-term macroeconomic framework. In this regard, I share the staff's view that a comprehensive discussion of macroeconomic conditions and how a lower growth outcome would be reflected in the prioritization of fiscal choices should be included in the PRSP progress report. The authorities are also encouraged to prioritize their actions with focus on measures with the largest impact on the poor, especially in the agricultural sector.

With these remarks, I wish the authorities further success.

Mr. Bakhache made the following statement:

The well-written and thought-out Malagasy Poverty Reduction Strategy Paper and the steps taken to start its implementation are a testimony to the authorities' determination to reverse the deteriorating economic and social conditions in the country following the 2002 domestic crisis. We note in particular the important modification to the interim PRSP that enhanced the participation of the Malagasy society and instilled more realism in the proposed scenarios. The Joint Staff Assessment clearly describes the significant effort that went into the preparation process of the PRSP and outlines its important strengths, particularly the high degree of ownership, the comprehensive poverty diagnosis, as well as the inclusion of short-term policy actions. We generally agree with the staff assessment and with many of the issues Directors raised including in particular on revenue mobilization and governance as highlighted by Mr. Misra, Mr. O'Loghlin and Ms. Cunningham in their statements. We would like to focus our remarks on two broad and related issues, namely implementation and the growth outlook for the country.

Notwithstanding the strong content of the PRSP, its effective operationalization requires a shift in the focus of the authorities from the conceptual work and the process of preparation towards improving a number of areas related to the implementation of the strategy. First, efforts need to be directed at costing and prioritization of the various actions and policies envisaged in the strategy which, among other things, would help match spending with the desired outcomes. In undertaking the costing exercise it is very important that the authorities take into account the need for higher recurrent expenditures that result from each program. Overlooking the potential for higher recurrent spending can undermine the poverty reduction effort and/or fiscal discipline in the country over the medium-term.

The absorptive and technical capacity in the country is another area where improvements are critical for the effective implementation of public policies. Indeed, given the well-known weaknesses in the country's implementation capacity, we have doubts about the ability of the authorities to carry out the ambitious programs and reforms outlined in the PRSP. While resource availability continues to be perhaps the most important constraint facing the poverty reduction effort in most HIPCs, strengthening of the technical, absorptive and implementation capacity would go a long way in improving the efficient use of public resources in all sectors. In the particular case of Madagascar, the transport, water and extension services as well as the health and education sectors should be accorded added attention in this regard. In addition, reforms in the public sector, including budget management, customs, and the judicial system - to mention a few- would not only improve the efficiency of the public sector but also enhance the confidence of the private sector in the ability of the government to make the best use of available resources. We very much support the provision of technical assistance from the Fund as well as other providers to help the authorities in their efforts to improve capacity. But, we have to recognize that improvements in this area take a long time to materialize. Expectations should be tempered accordingly.

Turning to the issue of the country's growth outlook and the prospects for poverty reduction, we note that the staff is less optimistic than the authorities. While Madagascar has a potential to grow as fast as the authorities' ambitious scenario suggest, achieving sustainable growth rates in the vicinity of 10 percent would require large amounts of foreign assistance as well as far reaching reforms aimed at enhancing the environment for private sector activity and instilling a high degree of confidence in the economy. Prevailing weaknesses in a number of sectors including most importantly agriculture and related sectors (such as irrigation, transport, and social services) as well as in the banking system present important challenges for the authorities. Their commitment to strengthen policy implementation and the evidence in this regard so far bode well for overcoming these obstacles. Sustaining a track record of economic reforms and stability oriented policies in the period ahead is, in our view, key to energizing economic activity and achieving the laudable goals of high growth and poverty reduction set in the authorities' strategy.

Mr. Rouai made the following statement:

I join other speakers in commending the Malagasy authorities for having prepared a very comprehensive PRSP, consistent with the MDGs after an intensive participatory process. I also appreciate the emphasis they put on the analysis of poverty, the importance of governance, and the need to design a development strategy that promotes a more diversified economy and fosters social protection.

The Joint Staff Assessment identifies a number of weaknesses, particularly program costing. The authorities are encouraged to address them during the implementation of the PRSP. While welcoming the use of two macroeconomic scenarios, I join Directors who consider the high growth scenario as overly optimistic. The use of optimistic projections in the PRSP, compared to a more realistic framework under the associated PRGF, goes beyond the case of Madagascar and could become an issue of policy concern. Over-optimistic forecasts could raise unrealistic expectations and reduce credibility of the process. During the Board discussion on aligning the PRSP and the PRGF in April 2003, Directors urged the authorities to align their PRSP with their national budget. If PRSPs are based on optimistic projections, the integrity of the budget exercise could be jeopardized as well as donor willingness to support the country's reform and poverty-reduction efforts. In addition, the use of high growth scenarios in the PRSPs could negatively impact its credibility and acceptance as a signaling device for post-PRGF countries. Staff may wish to keep this issue under review.

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

The staff representative from the African Department (Mr. Vaez-Zadeh), in response to questions and comments from Executive Directors, made the following statement:

Two questions came up during the discussion, one regarding private sector participation in the PRSP process, and the other regarding the reaction of private sector to the measures in the PRSP.

What was very clear during the process of PRSP preparation was that the authorities wanted the private sector to be very much involved, so in every workshop that was organized at every level, almost half of the participants were from the private sector. The private sector was also fully involved in setting priorities for various sectors, and will be involved in the monitoring of the implementation in the various working groups that will be monitoring the implementation of the PRSP.

On the whole, the reaction of the private sector, as far as the staff can gather, has been favorable to the strategy outlined in the PRSP. Directors may have noticed that there is much in the PRSP from which the private sector would benefit, including overall improvements in governance, reduction in corruption, improvement in the efficiency of the public sector with regard to red tape and bureaucratic hassles. Further, improvements in infrastructure and health and education will eventually be beneficial to the private sector, so on the whole the private sector has received the PRSP quite favorably.

Some doubts were also raised by Mr. Baukol about the small and medium enterprises and how credit to the sector will be increased. At least as far as we know, the authorities do not have any intention of addressing this problem through directed credit schemes. There will be emphasis on microfinance, and the authorities have set up a loan guarantee fund, which so far has become very active—it guarantees 50 percent of the risks for certain bank loans. The staff hopes this operation will expand. The risk environment for banks has also been reduced by the new Property Act which allows land to be used as collateral for bank loans, and some banks have already started lending small amounts of medium and long-term loans to small enterprises. On the whole there is some movement in this direction, but in general there is a lot more to be done because the small and medium-size enterprises require a lot of credit.

The staff representative from the World Bank (Mr. Van Eeghen), in response to questions and comments from Executive Directors, made the following statement:

> Mr. Srinivas' observation is correct that growth has not led to poverty reduction in the rural areas, which begs the question of what is happening in the agriculture sector. One of the Bank's findings in the agriculture sector is that agricultural productivity is almost directly linked to distance to roads. For example, there is almost a straight correlation between rice yields and distance to roads. The road network in Madagascar today is actually less functional than what it was at independence, essentially because maintenance has fallen short. This is one of the reasons why the new government puts so much emphasis on the building of infrastructure and maintenance. The results are quite encouraging. In past years, approximately 1,000 kilometers a year were being rehabilitated. Now it is 6,000 kilometers per year, and the government's intention is to increase that even further. The Bank staff is quite confident that once the road network is rehabilitated and once there are incentives for farmers to become more productive, this will have a significant impact on agricultural productivity and as a result on poverty reduction. There are other factors as well, such as the use of fertilizers, which the government is also emphasizing, and the use of water, which is being addressed in a watershed project with the World Bank. On growth projections, the government does project an increase in agriculture growth over the medium and long term, given that improving the road network will take some time before it yields the desired results.

Mr. Ondo Mañe made the following concluding statement:

> I would like to thank Mr. Vaez-Zadeh and his team for the excellent job done on Madagascar. Your advice and technical support has been instrumental in the design of the present PRSP. Also, I would like to thank the staff for the comprehensive answers to Directors' questions. Let me thank my colleagues for their advice and comments, and I can assure you that I will convey them to my Malagasy authorities.
>
> I recognize that my authorities have to improve issues related to governance, as noted by Mr. Duquesne and others on this same issue. My authorities have considered transparency and governance issues as key to their policy, and the staff just assured the Board that this government after taking the office has taken the governance and transparency issue seriously.
>
> I recognize also from Mr. Misra and Mr. Usman that the authorities have to improve the low level of domestic revenue. Further, I recognize the

importance of the development of agriculture and environmental issues raised by Messrs. Duquesne and Baukol and the importance of the private sector. I noted that technical assistance and capacity building are important elements for the success of the PRSP.

Finally, as this is the last mission for Mr. Vaez-Zadeh on Madagascar, let me take this opportunity to convey to him the appreciation of my Malagasy authorities for the excellent job done by Mr. Vaez-Zadeh as mission chief and wish him every success in his future endeavors. Let me thank colleagues for the strong support that has been shown for the reform effort made by my Malagasy authorities. This support is highly appreciated by my authorities and the people of Madagascar as the PRSP is the key document for their future development.

The Acting Chair made the following summing up:

Executive Directors welcomed the Poverty Reduction Strategy Paper (PRSP) for Madagascar and endorsed the Joint Staff Assessment of it. They considered that the PRSP provides a sound framework for raising economic growth, reducing poverty, and achieving the Millennium Development Goals in the context of macroeconomic stability, good governance, an expanding private sector, trade liberalization, and increased priority spending, particularly with regard to universal primary education. Directors concurred with the governance-related priorities presented in the PRSP, including ongoing efforts to fight corruption and to strengthen the budgetary process to make it more transparent and accountable.

Directors commended the high level of ownership of the PRSP noting that, over the past three years, the PRSP's preparation entailed substantial consultation throughout the Malagasy society, with significant participation of women. Donors were also consulted at various stages. These consultations were instrumental in diagnosing poverty; focusing the PRSP on the key priorities of governance, growth, and service delivery; and building support for the poverty reduction strategy.

Directors endorsed the prudent stance of macroeconomic policies aimed at achieving high economic growth, low inflation, a sustainable debt position, and a comfortable level of foreign reserves. They stressed the urgency of boosting fiscal revenue to ensure that adequate financing of the poverty reduction strategy is available. They commended the steps taken to improve customs administration, and encouraged the authorities to reduce ad hoc tax and customs duty exemptions.

Directors noted that the growth targets for 2004-06 are high compared to historical levels. They stressed that attainment of these targets will also require vigorous implementation of structural reforms to stimulate private investment and export diversification. Directors believed that the PRSP will challenge Madagascar's implementation capacity. They urged the authorities to focus on capacity building and on those actions that would have the strongest impact on the poor, particularly in rural areas.

Directors observed that the PRSP could be improved in a number of areas. In particular, the macroeconomic framework should be developed in more detail; the budgetary cost of achieving specific sector targets should be carefully assessed in the context of a medium-term expenditure framework; the analysis of poverty and the monitoring of poverty outcomes should be strengthened; and the strategy to facilitate access to financing for small and medium-sized enterprises should be clarified.

Directors agreed that the first PRSP progress report should, inter alia, assess the degree to which the conditions for economic growth have improved, especially in the agricultural sector where most of the poor live, discuss how a lower growth outcome than that envisaged would affect fiscal priorities and achievement of the PRSP's goals, and outline policies to promote the environmentally-sustainable use of natural resources.

The Executive Board took the following decision:

The Fund determines that the Poverty Reduction Strategy Paper for Madagascar set forth in EBD/03/89, 10/9/03, provides a sound basis for Fund concessional financial assistance. (EBD/03/101, Sup. 1, 10/30/03)

Decision No. 13133-(03/108), adopted
November 21, 2003

5. ISLAMIC STATE OF AFGHANISTAN—2003 ARTICLE IV CONSULTATION

Documents: Staff Report for the 2003 Article IV Consultation (SM/03/369, 11/6/03); Rebuilding a Macroeconomic Framework for Reconstruction and Growth (SM/03/315, 9/10/03)

Staff: Bennett, MCD; Fisher, PDR

Length: 2 hours

Mr. Mirakhor submitted the following statement:

Background

At the outset, my authorities express their gratitude for the Fund's policy advice and technical assistance received since January 2002. This assistance, which has been well-described in the staff document SM/03/315:

Islamic State of Afghanistan—Rebuilding a Macroeconomic Framework for Reconstruction and Growth, has focused on establishing a sound foundation for economic management and macroeconomic stability. The authorities' achievements are also well-summarized in the document as well as in the excellent staff report. My authorities also thank the staff for the fruitful dialogue leading to completion of the Article IV consultation discussions with Afghanistan, the first in twelve years. This is an important step toward resumption of normal relations with the Fund and the international development community. The authorities are also immensely grateful to the international community for its role in restoring peace and security to Afghanistan and in its reconstruction. Twenty years of conflict, interspersed with severe natural disasters, had devastated the Afghan economy, destroyed government institutions, administrative capacity and infrastructure, and created a huge refugee problem and deep poverty.

With financial and technical assistance from the international community, the authorities have made major strides in restoring a credible policy framework and functioning institutions, and have achieved progress in turning the economy around in key areas. Economic growth has rebounded and macroeconomic stability is taking root. The private sector is again playing a key role in economic activity, and the government is facilitating this role by building infrastructure needed for a liberal, market-led economy. The authorities realize the enormous challenges ahead—particularly regarding peace consolidation, economic reconstruction, dealing with undesirable informal activities, and alleviating poverty—and are resolved to address them with the continued support of the international community. They firmly believe that their solid track record of implementation of sound economic policies—with emphasis on institution building, accountability, and transparency—and their strong commitment to the development of a private-sector-led economy will provide a firm foundation for sustainable growth and poverty reduction as the security situation improves and political stability is consolidated.

Recent Economic Developments and Policies

Real Sector:

Real GDP has rebounded strongly in 2002/03, while inflation has abated. Significantly, the real GDP growth of almost 30 percent (excluding opium production) has been broad-based. Agriculture—the largest sector—has shown strong growth, helped by good rainfall and increased cultivation after seven years of drought, large-scale famine, and huge unemployment in the sector. An impressive wheat and cereal harvest has resulted in self-sufficiency for some regions, while providing much-needed jobs. Importantly also, production of raisins, fruits, and walnuts—premium export crops—has recovered strongly.

Construction and services, supported by donor financing, have expanded rapidly. The housing sector activities are brisk, and repair and reconstruction work, led by the private sector, is visible in all major cities. The Afghan Commerce Department has granted more than three thousand business licenses over the last two years. Manufacturing activities are picking up slowly, but steadily. Returning expatriates are engaged in light manufacturing of furniture and construction activities, while larger-scale manufacturing projects, e.g., cement, beverages, and bottled water are gaining foothold in the economy. The carpet-weaving industry, with a high export potential, is returning to the country following its emigration during the years of conflict. The government has dedicated a special enclave for reinstallation and nurturing of this industry. A number of projects in the telecommunication and hotel sectors have started, and activity in the service sector is picking up momentum. In mining, a team of experts is assessing the country's potential. Afghanistan's untapped reserves of oil and natural gas are already in exploitation in the Northwestern region. Furthermore, a feasibility study is being funded by the Asian Development Bank to run a natural gas pipeline from Turkmenistan to Pakistan. Afghanistan could expect substantial revenue in transit and easement fees by allowing the Turkmen natural gas to reach South-Asian markets. Other untapped underground reserves include iron, copper, lapis lazuli, emerald, and gold.

Fiscal Sector:

Emerging from a chaotic situation where budget execution lacked cohesion, the authorities were able, in a short span of time, to articulate a coherent and consistent budget for 2003/04. Underpinned by the "no overdraft rule" that precludes monetary financing of the budget, fiscal discipline, accountability, and transparency have guided the authorities' policy framework. After a slow start, the pace of execution of the 2002/03 operating budget increased to reach over 90 percent of earmarked expenditure. Significantly, domestic revenues overperformed and were over 50 percent higher than budgeted. Consequently, the financing requirement was lower than projected, and was met largely from donor assistance. The development budget, however, was small as a result of administrative capacity constraints and since most of donor disbursements was focused on humanitarian aid and channeled outside the budget.

Significant progress has been made in fiscal reforms with technical assistance from the Fund, the World Bank, and USAID. Regarding expenditure, implementation, control, and transparency have been strengthened, including through computerization of expenditure recording, payment processing, and financial reporting across the country. Substantial progress has been made in the consolidation of government bank accounts to enhance efficiency in the management of treasury funds. The World Bank has funded an Emergency Public Administration Project to provide international contractors in financial management, public procurement, and audit, while helping to build local capacity in these areas. The transfer of revenue by the provinces and the reporting of non-wage expenditures have improved, and trained Afghan fiscal advisors are assisting with financial reporting to the center.

As regards revenue management, customs are being modernized, while a far-reaching policy reform package has been approved by cabinet, including the use of market exchange rate in customs valuation, reduction in the number of tariff bands, and lowering tariffs. Customs clearance procedures are being simplified and a five-year plan to strengthen customs administration is contemplated. Tax policy and administration are being reformed, including through reduction of the top marginal rate for individuals and increasing personal exemptions, restoration of wage withholding on higher-income employees, introduction of a rent tax and airport fee, and expansion of the business receipts tax to cover certain expatriate services. Furthermore, a large taxpayer unit (LTU) is to be established by end-2003 to administer the personal income tax, business receipt tax, and the new rent tax. Concurrent civil service reform is also making progress. Remaining challenges include addressing professional capacity limitations, reducing over-staffing, and restructuring the pay system to attract, motivate, and retain skilled staff.

Monetary Sector:

With the assistance from the Fund and other agencies, a new Afghan currency was successfully introduced as an important symbol of national identity. The Da Afghan Bank (DAB) assumed full control over the withdrawal and destruction of old banknotes as well as the printing and issuance of the new unified national currency, which was completed without any social disruptions. The monetary policy framework is based on indicative money supply targets despite the difficulty of the task in a highly dollarized economy. A foreign exchange auction system has been developed and, currently, serves as the main instrument of monetary control. Auction decisions are based largely on exchange rate movements, and monetary growth has been in line with the DAB monetary program. Under the DAB's policy and the no-overdraft rule, the expansion of the money supply is closely matched by the accumulation of reserves.

The recent passage of new laws for the central bank and the commercial banking system has laid the foundations for an independent, accountable central bank as well as an efficient, well-supervised, and modern financial system. The DAB operational capacity has been strengthened, including through computerization and establishment of a supervisory department, while measures have been taken to improve the domestic payments system and to facilitate international payments. The stability of the exchange rate since January 2003 and the prudent monetary and fiscal policies have kept inflation in check. At present, the managed float regime is serving Afghanistan well, allowing the DAB to conduct limited sterilization operations while gradually building up reserves that reached about $568 million by September 2003 to provide a cushion against shocks. The balance of payments is driven by donor assistance, largely in form of grants, which finances a large current account deficit and allows a reserve build-up.

Economic Outlook and Policies for 2003/04:

Sustained high growth will be critical for the socio-economic resuscitation of Afghanistan. Prospects for continued economic recovery are bright, but contingent on continued favorable weather conditions, improvement in the security situation, and donor support. In 2003/04, further strong growth in agriculture, construction, and services is expected to support real GDP growth of about 20 percent; inflation is expected to remain very low; and gross international reserves are expected to increase further. Economic diversification, led by the private sector, will be critical in achieving high growth and reducing the economy's vulnerability to shocks.

Fiscal management will be further strengthened, geared to fostering long-term sustainability. Improving revenue mobilization will be key to this effort. While significant donor assistance will be needed over the medium term, the authorities realize that they cannot indefinitely rely on donor contributions to fund their operating budget. Further effort will be made in tax policy and administration reform; staff recommendations regarding revision of the income tax, introduction of a wage withholding tax, and a service tax are being considered. The authorities regard a progressive, transparent, and simple tax system as having the best chance of maximizing compliance. Strengthening fiscal management of the provinces remains a priority, and efforts to consolidate government accounts to achieve effective revenue centralization and central government control over provincial finances will be reinforced. The authorities recognize the importance of civil service reform for fiscal sustainability, but realize that they need to proceed cautiously to minimize potential social and political costs. They intend to proceed with selective salary improvements and wage decompression, together with actions to improve capacity so as to promote a productive and well-remunerated civil service. In the same vein, while the authorities recognize the benefits of state enterprise reform, this will need to be implemented gradually. They plan closure, or divestment, of public enterprises through an open and transparent process.

The preparation of the 2003/04 budget shows a marked improvement. Domestic revenues are expected to rise significantly above the 2002/03 outcome, with collection in the first quarter of the fiscal year indicating considerable improvement over the same period last year. Although expenditure implementation started slowly, following delays in ministerial spending submissions and in payroll disbursements to provinces and security forces, it is expected to gain momentum over the year, reflecting the large reconstruction and social needs and improved administrative capacity.

The National Development Budget, based on the reconstruction road map and the priorities of the Afghan government, is underperforming since actual donor support in the first half of 2003/04 has reached only 30 percent of the US$1.8 billion targeted for infrastructure, rehabilitation, health, social protection, assistance to refugees, and education. We welcome the recent announcement of a US$1.6 billion assistance package which will be spent on security and training of new police and conscripts of the Afghan National Army (ANA), logistics expenditure for the upcoming presidential elections, and various emergency reconstruction projects. It is critical that other donors come forward too, so as to help ensure that the development program can be undertaken on the scale and pace required, and not be unduly constrained by shortfalls in financing. We look forward to a positive outcome from the forthcoming donors' conference planned for early next year.

Maintaining low inflation through control of monetary growth will continue to be the objective of monetary policy. While exchange rate stability will also serve as an anchor for price stability as well as engendering confidence in the new currency, the authorities intend to continue to administer the managed float cautiously and will avoid intervention for any prolonged period in order to reflect market trends and to protect foreign reserves. Following the adoption of the central bank and banking legislation, the authorities intend to further strengthen supervision and to promote financial intermediation and financial sector development. With Fund assistance, the authorities intend to put in place new legislation to counter money laundering and the financing of terrorism. Furthermore, the "Hawala" money transfer system will be subject to greater regulation and scrutiny. Problems of the existing state-owned banks will be addressed on a case-by-case basis to minimize budgetary costs and risks to the banking system. Options in this regard include restructuring, privatization, and closures when deemed appropriate.

While the external outlook is uncertain, being dependent on the security situation, as well as on the pace of reconstruction and economic recovery, current account deficits will remain high, and continued donor support will be critical. In addition, there is need to maintain a cushion of reserves against potential shocks. Moreover, given the present limited capacity to service new external debt, non-concessional borrowing is not a viable option. Therefore, donor grants and generous relief on existing debt will be crucial in funding the development program and ensuring external sustainability. The authorities have achieved some success in negotiating cancellation of bilateral debt. They hope to reach a resolution with the Russian

Federation on claims that constitute the bulk of the external debt. A debt management system has recently been established to build capacity for tracking and ensuring timely future debt-service payments. While the de facto exchange system is free of restrictions, the authorities plan to establish the legal foundation for a liberal trade, payments, and exchange regime with Fund technical assistance and are working toward accepting obligations under Article VIII of the Fund's Articles of Agreement at the appropriate time.

Informal opium production is equivalent to 40-50 percent of GDP and generates (unrecorded) export receipts estimated at over $2 billion. It also supports the livelihood of a large number of the rural population. Under the circumstance, an abrupt eradication of production is bound to have immense adverse socio-economic effects. As the staff rightly indicates, a successful eradication program should be buttressed by extensive programs to develop alternative productive sources of livelihood as well as provision of requisite social support. The authorities are committed to an effective eradication program and call for maximum financial support of the international community in this regard.

Future Engagement with the Fund:

My authorities recognize and appreciate the Fund's role in providing the much-needed policy advice and technical assistance in managing critical areas of the economy to complement the assistance from other development agencies. As the Minister of Finance indicated at the Annual Meetings in Dubai, the authorities are eager for a closer Fund involvement in Afghanistan in the context of a PRGF-supported program. This will provide a framework for policy discipline and credibility. My authorities have already demonstrated a strong commitment to implementation of sound policies and consider that closer Fund engagement will allow them to mitigate some of the very constraints and risks alluded to by the staff. They believe a PRGF-supported program would send a strong signal, both domestically and internationally, of their readiness and capacity to design and implement a growth- and poverty-reduction strategy to place the economy on a sustainable and strong economic and social development path as they consolidate political and economic stability. For now, however, they agree with the staff's recommendation to start with a staff-monitored program to continue building on their strong policy track record. They look forward to the Board's support for a PRGF-supported program after the presidential elections in the autumn of 2004.

Once again, my authorities are grateful to the Fund staff, management, and the Board as well as to the development community for their support. They hope that they can continue to count on this support so as to meet the difficult policy and reconstruction challenges that lie ahead.

Mr. Reddell submitted the following statement:

Key Points

-There have been some encouraging developments in Afghanistan but the environment remains more than usually difficult and not conducive to longer-term investment.

-Some more cross-country work, both on managing a drug-producing economy and on the role of institutions in establishing a climate for sustained growth, would have been useful additions to the report.

-The Fund's technical assistance efforts and policy advice role should be commended and should continue.

-Further thought is needed on whether it will be appropriate for Afghanistan to take on more debt and enter into a program relationship with the Fund.

It is an early economic milestone on Afghanistan's long and multi-faceted journey towards normality that we can today discuss an Article IV staff report, after an interruption of so many years. That is so even though the country remains plagued by security problems and has little of the data or institutional capacity that we would normally associate with policy discussions and advice. Between this paper and the earlier paper, *Rebuilding a Macroeconomic Framework for Reconstruction and Growth*, there is a wealth of helpful information of developments in Afghanistan.

What has been achieved to date on the macroeconomic policy front is encouraging. Monetary and fiscal discipline has been maintained through the period of transition and a flexible exchange rate system is now operating satisfactorily for the new currency. In addition, the structural reform that has been achieved so far, while perhaps inevitably limited (by both capacity and political constraints), is also welcome.

Nonetheless, as the staff make clear, all this goes only so far. A lengthy reform agenda needs to lie ahead. And yet, the security situation is described as "very fragile" (exemplified by this week's UN decision to withdraw aid workers from large parts of the country), in a country where there still appears to be little sense of national cohesion, the first election is due within months, and government domestic revenue is equal to little more than 2 percent of total GDP. Although economic activity has grown strongly in the past couple of years, that success has rested on the unreliable cocktail of favourable weather, aid flows and opium output.

The opium problem is a particularly difficult challenge: the scale of output (relative to the overall size of the economy) is huge; as the staff notes, climatic conditions suit cultivation of poppies; and, in the near term at least, there appears to be few other equally-remunerative options for many farmers. As with other economies where drug production is a major issue, there is a real tension between efforts to reduce demand in consuming countries and those to reduce supply directly. It might have been helpful—both for the Board and for the authorities—if the staff had been able to include in its report some analysis based on the experiences of other countries (for example, Colombia and Bolivia), and also if they had been able to offer some thoughts —drawing on the work other agencies must have undertaken—on what alternative export options are likely to be available to the Afghan economy as a whole in the short to medium term (say, the next 5-10 years).

The Fund has played an important role in the provision of technical assistance and related advice to the Afghan authorities in the past couple of years and this substantial role seems set to continue. We applaud the involvement of the Fund in this role and are greatly encouraged to read, for example, of the success of the currency conversion program. We were also encouraged to read, in a recent issue of *IMF Survey*, an interview with one of the MFD staff who has been involved in the Fund's work in Afghanistan which highlights the flexible and pragmatic approach, responsive to the particular needs and circumstances of the country, being adopted by the Fund.

Looking ahead, it seems likely that the most useful role that the Fund can play in Afghanistan is in the provision of technical assistance and close engagement in policy dialogue in the areas of the Fund's own expertise. Linked to that, we see a vital role for the Fund in helping bring the experiences of other countries into the policy dialogue. (On that front, we were a little disappointed that the staff report did not pick up some of the excellent work the staff has done in recent years on the importance of robust economic and political institutions for sustained strong economic growth.)

The paper notes the possibility of a move towards a formal program relationship. Although moving beyond a staff-monitored program is likely to take some time, the already high levels of debt, weak domestic revenue mobilization and the longer-term development focus of Afghanistan's needs, mean that we would urge the staff and the authorities to consider carefully whether incurring debt to the Fund is the best way forward.

In Afghanistan today, it is perhaps more starkly apparent than is often the case that sustained economic growth and material improvements in living standards will be likely only if there a strong sense of national ownership, to put in place the sorts of policies and build the sorts of stable, robust, and peaceful institutions that will provide a climate in which investors can expect to see sustained secure returns from their capital: physical, financial, and human. The international community has a part to play and many of the nations represented at this table are playing an active role in helping the Afghan authorities stabilize and rebuild their nation. Nevertheless, what must be done must ultimately be done by, and with the assent and support of, the Afghan people.

We wish the authorities every success in the monumental challenges they will continue to face in the years ahead.

Mr. Misra submitted the following statement:

Key Points

-Afghanistan faces a daunting task of reconstructing a ravaged economy. Notwithstanding the still fragile security situation, the overall outlook is positive.

-Within a very short time, a good macroeconomic framework has been put in place. A dysfunctional financial system has been made operational, a new currency has been introduced, and the budget process has been re-established.

-Economic recovery is gaining momentum, with strong GDP growth encompassing agriculture, premium export crops, construction and services. Manufacturing activities and the export oriented carpet making industry are beginning to revive. Exploitation of the hitherto untapped oil and natural gas reserves and implementation of the gas pipeline project could unleash new sources of growth.

-The agreement signed by the provincial governors on transfer of revenue from states is a major breakthrough.

-The authorities' strong commitment to sound macroeconomic management is manifest in major steps like refraining from monetary financing and reforms like privatizing commercial banks, even in a fluid situation. In assessing progress, it is important to be mindful of the authorities' severe capacity constraints. Caution should be exercised against overloading the policy agenda and creating unrealistic expectations, especially among donors.

-Given its linkages with criminals and terrorism finance and the potential for destabilizing the government and derailing the democratic process and rule of law, the authorities have a vital stake in quickly eradicating poppy cultivation. Considerations like adverse income, growth, and BOP implications should not hold them back. However, their efforts are bound to be constrained until the government's authority is fully extended. A long-term solution lies in providing the rural population with viable economic alternatives.

-While the authorities need to stay the course, there should be no let up in support from the international community. There are worrying indications of this crucial support waning. Restoration and maintenance of stability in Afghanistan has global implications. Donor fatigue may undo the substantial effort and resources that the international community has invested in Afghanistan over the last two years.

-A Fund-supported program can provide a strong basis for donor coordination, and facilitate Paris Club debt restructuring and HIPC debt relief. A staff-monitored program, as an interim arrangement, can be utilized for improving implementation capacity, while the domestic political and security environment also stabilizes. The advantages of a closer Fund engagement outweigh the possible risks to a program.

We welcome today's discussion as an important milestone in the process of Afghanistan's return to business as usual as a member of the international financial community. We commend the staff for providing an objective assessment of the situation and Mr. Mirakhor for his candid and insightful statement.

The challenges facing the Afghani authorities are daunting. They have decades of economic decline, destruction of infrastructure, and collapse of institutions to reverse. This long period witnessed steady impoverishment of the people and significant deterioration in social indicators. The formidable task before the authorities is complicated by the improving but still fragile security situation.

While we agree with the staff's analysis regarding the three serious risks to economic recovery, the outlook in our view is positive. The authorities have begun well and are on the right track. In a short time, a dysfunctional financial system has been made operational, the challenging task of introducing a new currency and withdrawing old banknotes has been accomplished, and the budget process has been re-established. Procedures have been laid down for ensuring fiscal discipline and preventing resort to monetary financing, and computerized systems of processing payments and reporting are in place. The low base and unreliability of data should not detract from the strong GDP growth projected in 2003-04. Inflation has abated, agriculture and premium export crops have shown strong growth, and, helped by donor financing, construction and services have expanded. Manufacturing activities have also begun and the carpet-making industry, with a huge export potential, is re-establishing itself. These are impressive achievements, given the severe constraints.

We welcome the authorities' resolve to consolidate these gains by implementing an impressive agenda of measures to strengthen fiscal management, streamline tax administration, improve civil service functioning and budget execution, reform state enterprises, and undertake large-scale reconstruction of social and physical infrastructure. The agreement signed by the provincial governors on transfer of revenue from states is a major breakthrough, given the existing delicate balance of power. Happily, this arrangement appears to be already getting implemented. Steps are also being taken to put the customs administration back on the rails. These are timely measures that should ensure, over time, a sustainable underpinning for the country's public finances. Even in the midst of the current fluid situation, the authorities have taken important structural reform decisions like privatizing the commercial banks. Such measures testify to their commitment to facilitating the development of a private-sector led open economy. Exploitation of the hitherto untapped oil and natural gas reserves and implementation of the gas pipeline project, which has been under consideration, could unleash new sources of growth. We agree with the staff's comments about the importance of expediting civil service reform and the specific measures suggested by them. However, we would like to emphasize that it is important to be mindful of the severe capacity constraints of the authorities. We would, therefore, urge caution against overloading the policy agenda and creating unrealistic expectations, and consequent disappointment, especially among the donor community.

The staff report, as well as several other recent publications, refers to the risk posed by buoyant poppy cultivation. The staff report also refers to the adverse income, growth, and BOP implications of an abrupt eradication of opium production, a point underscored by Mr. Mirakhor. However, these considerations should not hold back the authorities. We believe that, given its linkages with criminals and terrorism finance and the potential for destabilizing the government and derailing the democratic process and rule of law that was so assiduously put in place, the authorities have a vital stake in quickly eradicating poppy cultivation. Having said that, we recognize that their efforts will remain constrained until the government's authority is fully extended and a long term solution lies in providing the rural population with viable economic alternatives. We, therefore, look forward to the implementation of the national rural development program. As law and order is restored and economy recovers, the authorities should find it increasingly easy to wean people away from poppy cultivation. While on this subject, we welcome their commitment to put in place necessary legislation to tackle money laundering and terrorism finance.

We are sanguine that, as the political and security situation progressively stabilizes, economic growth will gather greater momentum. What is required is that the authorities stay the course and that there is no let up in support from the international community. We would like to elaborate and emphasize the latter point, as there are worrying indications of this crucial support waning. The National Development Budget, based on the reconstruction road map and the priorities of the Afghan government, is underperforming since actual donor support in the first half of 2003/04 has reached only thirty percent of the amount targeted for infrastructure, rehabilitation, health, social protection, assistance to refugees, and education. Since non-concessional borrowing is not a viable option, given the present limited capacity to service new external debt, donor grants and generous relief on existing debt will continue to remain crucial. As we see it, the task of Afghanistan's economic reconstruction is a challenge as much for the world community as it is for the Afghani authorities, given the global implications of restoration and maintenance of stability in Afghanistan. We are concerned that donor fatigue may undo the substantial effort and resources that the international community has invested in Afghanistan over the last two years.

In this regard, we believe that a Fund-supported program can be helpful in providing a strong basis for donor coordination. This could also facilitate Paris Club debt restructuring and HIPC debt relief. The Fund is already providing policy advice and technical assistance to Afghanistan, and the authorities have demonstrated their commitment to sound macroeconomic policies in the face of an extremely challenging situation. A staff-monitored program, as requested by the authorities, will provide them with the opportunity to consolidate their achievements and demonstrate continued commitment to sound macroeconomic management, paving the way for a financing arrangement. This interim period can also be utilized to improve implementation capacity with enhanced technical assistance and stabilize the domestic political and security environment. A Fund-supported program will provide requisite assurance of confidence in authorities' policies and serve as a signal of the international community's continued support. Further, as Mr. Mirakhor points out, a PRGF-supported program will help mitigate some of the constraints and risks the staff has alluded to and provide a framework for designing and implementing a growth and poverty-reduction strategy. Overall, we believe that the advantages of a closer Fund engagement outweigh the possible risks to a program.

Finally, we wish the Afghani authorities all success in their challenging endeavors.

Mr. Le Fort and Mr. Costa submitted the following statement:

We thank the staff for their succinct report and Mr. Mirakhor for his informative and encouraging statement. We welcome the first Article IV discussion on Afghanistan in 12 years as a signal of advances in overcoming the unstable political conditions that have prevailed in the country. This in itself tells about the precarious initial conditions in Afghanistan when the process of reconstruction began a little more than a year ago from seriously damaged and weak infrastructure, unavailable government accounts for the last decade and practically non-existent administrative capacity. On that basis, it is, indeed, commendable what the Interim and Transitional administrations, originated with the Bonn Agreement of December 2001, have achieved towards the goal of making Afghanistan a peaceful, democratic state.

We welcome, particularly, the settling of arrears with the Fund, the World Bank, and the AsDB which has opened the possibility of new assistance and, in the case of the World Bank, this has already taken place through the utilization of IDA grant funds. We share the view that, at this early stage, the financing needs of the government, which are largely concentrated in the operational budget, should be met by donor grants rather than by loans even if these were concessional. The provisional debt sustainability analysis done by the staff confirmed the limited capacity of Afghanistan to service new external debt. It also highlighted the need for debt forgiveness and we commend the decisions taken in this regard by Denmark, China, and Germany.

We welcome the role of the Fund in providing policy advice and technical assistance support in the key areas of financial sector, tax legislation, and in the introduction of the new currency completed in January this year, which has been a very successful undertaking. Continued cooperation in the area of technical assistance will be needed. As to the possibility of greater Fund involvement, for example in the context of a Fund-supported program, the staff clearly highlights the present limitations, in particular regarding data availability and institutional and administrative capacity. The preliminary agreement between the staff and the authorities to proceed first with a staff-monitored program (SMP) that may lead in time to a PRGF arrangement, seems to us an effective way to address the need to guarantee a sound macroeconomic adjustment which could, in turn, serve to sustain the high level of donor support that will continue to be needed in the foreseeable future.

It is noteworthy that donor fatigue is presented by the staff as one of the main risks that clouds the sustained recovery of the economy. Two other key risks are the security situation and the reemergence of opium in the economy. Progress in reconstruction is tied to the security situation, which remains a serious hindrance. As to the narcotics-related risk, it is to be expected that forced solutions will not be attempted and that the experience of other countries suffering similar problems will be fully incorporated into the strategy to be followed. The problem in this regard is that there are not many successful experiences that could be imitated. The staff’s comments would be appreciated.

Clearly, most of the risks to Afghanistan’s outlook could be diminished in a scenario of sustained, high growth. Mr. Mirakhor rightly emphasizes this point. In this regard, there is, however the major risk represented by the vagaries of the weather given the predominantly agricultural character of the Afghanistan economy. It is, therefore, a priority to continue with the repairs to the irrigation systems and to improve the quality of agricultural inputs. Even more important is to start building up a reserve fund to reduce the fiscal impact when the weather conditions turn unfavorable, while pursuing at the same time a diversification of economic activity. Another pillar of growth in coming years will be the construction sector, which is largely supported by donor inflows channeled through the government's development budget.

The development budget mixes, however, humanitarian and reconstruction projects so that overall figures for the development budget may be misleading in terms of the real progress in improving infrastructure. It is a matter of concern that donors' commitments are still about 30 percent short of the donors funded projects identified in the national development framework. In this regard, not only could a SMP be helpful in eliciting donors' contributions but, more importantly, progress in implementing the five principles supporting the national development framework could also be very effective. Among them, the third principle, referring to the fact that aid cannot be effective without the state investing in human capital and the creation of an institutional framework that allows for the rule of law to prevail, is in our view a key one. These issues are critical in themselves but even more so if a new needs assessment focused on reconstruction projects is prepared, as suggested by the staff, since then the gap between needs and commitments will most likely increase substantially. The staff's comments would be appreciated.

On the fiscal policy front, we welcome the adherence to the no-overdraft rule and the continued improvement in revenue collection, in particular the increase in transfers from the provinces to the center. We look forward to the early enactment of the customs policy reform package including the use of the market exchange rate for customs valuation and the streamlining of tariffs. We would like, in this regard, some clarification as to what further steps are needed for the final approval of the customs reform package. Further efforts are needed, however, in civil service reform to upgrade its quality. We share, in this regard, the authorities intentions, highlighted in Mr. Mirakhor's statement of minimizing the potential social and political costs attached to necessary reform of the civil service.

Turning now to monetary policy, we welcome the fact that monetary expansion so far this year has been consistent with the monetary program even when the increases in money supply occurred through foreign exchange rate intervention, by means of auctions, directed at avoiding excessive fluctuation of the exchange rate while containing pressures towards a nominal appreciation of the exchange rate. The accumulation of foreign exchange reserves have resulted in reserve coverage of almost three months of estimated imports. As the staff indicates, the central bank (DAB) has used movements in the exchange rate as an early indicator of changes in the demand for domestic currency. To what extent is the intervention directed towards fixing the exchange rate, notwithstanding the existing commitment to a managed float with a no predetermined path for the exchange rate and to the staff's suggestion that a lightly managed float is the more appropriate exchange rate choice for Afghanistan? The staff's comments would be welcome. We wish the authorities continued success with their challenging tasks.

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

We welcome a long absent member back to the Board, even more so after the twelve-year absence. It is truly difficult to overestimate the amount of work from both the authorities and the Fund staff that has gone into bringing this Article IV consultation to life. Given continuing serious security concerns and the lack of much of the necessary economic data, it is especially remarkable that we have two interesting papers before us today. Indeed, the SM/03/135 could be easily called "A manual on how to build an economy" as it provides most insightful and hands-on analysis of the issues facing the country embarked on this road. We thank the staff for a set of high-quality work papers and technical assistance made available to Afghanistan.

As the staff papers rightly emphasize more than once, there are numerous risks before the country, which are fluid and not easily subdued. Yet, there are also some positive indications in the country's economic development and a few major reforms have already taken place. Most importantly, there seems to be a productive dialogue between the authorities and donors on the reform prioritization and implementation. Given the accumulated experience of the international community in transition and post-conflict countries, it would be essential to apply it in the case of Afghanistan so as to achieve success without exerting undue hardship on the already exhausted population. Allow us to comment on a few areas where we hope this could be accomplished.

Opium Production

While the dangers stemming from poppy cultivation are obvious, there seems to be an urgent need to emphasize that international effort is essential in accomplishing its successful eradication. We are glad that there appears to be a general agreement on this issue. The proposals in the paper regarding the ways to go about it are sensible (Box 6 and SM/03/315) and we are ready to support them. However, we are also all too well aware that such proposals existed before in other countries that produce detrimental drugs. While eradication has taken place, it was not followed by the original pledges "to undertake extensive programs to develop alternative livelihoods for farmers..., as well as to provide social support." To this end, the international community can ill afford to let Afghanistan follow the path of some other countries where the consequences of unimplemented promises have truly proven to be grave.

In this context, we would urge the staff to be restless in emphasizing the importance of creating alternatives for farmers. It is also imperative that an updated needs assessment is prepared as soon as possible.

Fiscal Policy

While many countries are struggling with fiscal decentralization, the opposite is taking place in Afghanistan. Centralization of revenues has become one of the government's top priorities and we welcome the efforts that are being undertaken in this area. At the same time, the fact that the government's control of provinces is still very limited is a serious concern. And, while a workable national fiscal process dating from before the conflict remained nominally in place, the country has got accustomed to the de facto fiscal autonomy of the provinces. These uncertainties surrounding the creation of a centralized system call for even stronger efforts in other areas of a fiscal framework, such as increasing central government revenue, reforming customs administration and improving expenditure management. While privatization may seem like one of the quick ways to raise cash, we would caution against hasty moves in this direction. Granted, there are not that many viable enterprises to be put on the market; nonetheless, the privatization should commence when the necessary structures are in place, including governance and a social safety net.

Monetary Policy

The staff has done an excellent job in laying out the alternative exchange rate choices for Afghanistan in SM/03/315. Based on the analysis and the available data, it does seem that a flexible exchange rate arrangement indeed serves the country the best, as it improves the ability to tolerate external shocks and safeguards the level of international reserves. At present, the authorities are trying to preserve relative exchange rate stability through an unofficial band. While such stability is certainly desirable for a country where the exchange rate is the only available public and monetary anchor, we agree with the staff that tight management of the exchange rate is not advisable at this stage. Too rigid of a band can communicate a false sense of security about the exchange rate movement, and the authorities' intention not to extensively use foreign exchange reserves to defend the exchange rate level at times of serious pressures is yet to be tested. Also, right now the exchange rate seems to be the only reliable indicator of monetary conditions and, therefore, it should not be suppressed. In general, we very much share the staff's views that the exchange rate arrangement could be revisited once the initial structural changes take place.

Debt Management

There is no doubt that Afghanistan's debt management capacity is limited, which is further supported by the fact that all the debt data seem to be lost. Given the country's limited ability to service debt and its high dependence on concessional financing and debt restructuring, it is most appropriate that the debt management unit has been established. Now its goal is to become fully operational. In regard to Afghanistan's debt to Russia, the Russian authorities are prepared to provide generous debt relief and take into account the current difficult situation in Afghanistan. To proceed with this, the mutually acceptable understanding on the status and size of this debt should be reached as soon as possible.

Involvement with the Fund

We would welcome s staff-monitored program (SMP) with the Fund given the preconditions are in place for a safe staff travel. Going forward, it would be premature to discuss a PRGF arrangement or HIPC eligibility, for that matter, before the 2004 elections. We are rather concerned that weak ownership and data collection could stand in a way of putting a viable Fund program in place. We also share Mr. Reddell's point that assistance through grants rather than loans could serve Afghanistan better, at least in the short term. For now, we look forward to observing Afghanistan's performance under the SMP.

Donor Support

The staff cross-country analysis in SM/03/315 does not offer a comforting conclusion regarding donor support to Afghanistan. It states that donor support has been considerably lower than in other post-conflict countries, has somewhat disintegrated, and mainly covered humanitarian needs. It also strongly emphasizes the dangers that could come from sooner–than-expected decline in donor support, and considers such an option imminent. While no country should become a victim of donor-induced Dutch disease, there still should be enough available assistance provided to guide Afghanistan through the early stages of reconstruction. Thus, we encourage the international community to base its assistance on pledges that truly correspond to the needs and follow through with the intentions to sincerely help Afghanistan in its efforts to eventually become self-sufficient.

Mr. Al-Turki submitted the following statement:

I welcome the end of the long hiatus in the Fund's Article IV consultations with Afghanistan. Before I turn to the discussions, I must first thank the staff for the highly informative and helpful report and background paper for today's discussion. This is a truly impressive achievement in the face of the extreme paucity of data and the country's difficult conditions. Together with the comprehensive statement of Mr. Mirakhor, the documentation provides an insightful basis for a forward-looking view of the economy's challenges and prospects.

The staff documents indicate the country's remarkable progress under the policies of the Afghan Transitional Authority (ATA). There has been a significant revival of the basic institutional and physical infrastructures essential for the economy's orderly reconstruction and development. This is an encouraging first step toward ensuring a lasting recovery from the devastations of prolonged war, successive natural disasters, and the legacy of egregious governmental mismanagement. I commend the ATA for this creditable achievement.

The magnitude of the progress so far is indeed evident from a glance at the starting point that the staff outlines in Box 1. That said, the evidence is also clear on the fragility of the improvements and the formidable challenges that remain for a lasting recovery. Here, I fully share the staff's stress on the risks and uncertainties resulting from the security conditions, the revival of opium production, and the availability of donor assistance.

The economy has been clearly responsive to the authorities' policy improvements. The strong recovery in activity, albeit from a very low level, has continued this year in an improving context of inflation containment, fiscal prudence, and rising external reserves. I welcome the broad-based nature of the output gains, which has included diversification of the non-opium agricultural export base. It is evident that the donor-supported expansion in the infrastructure and the public services is facilitating absorption of the returning Afghan refugees into a wide range of productive activities. The resulting economic buoyancy is also buttressed by the prospects of possible larger initiatives, including the projected development of the telecommunication services and other infrastructural projects.

On the fiscal policy front, continued adherence to the "no-overdraft rule" is important to further enhance the country's improved policy credibility. The fiscal progress is evident from both the improvements in budget formulation and execution, and the ongoing revenue growth well in excess of earlier expectations. In that connection, the marked improvement this year in the transfer of revenues from the provinces to the central government is a particularly welcome development. It is important now to ensure timely execution of the budgetary expenditures. In that connection, I endorse the Fund's readiness to help with further technical assistance. Indeed, a continued timely provision of the needed Fund technical assistance is crucial at this early stage of the country's recovery effort.

Arguably, renewal of monetary policy management, including the introduction of a new currency and restoration of the Da Afghan Bank, is the most visible of the authorities' achievements. The "no-overdraft rule" for budget financing has ensured monetary discipline by effectively tying the domestic liquidity growth to the build-up in reserves. Given also the extensive and growing dollarization, the scope for an active monetary policy is indeed limited. At the same time, the existing policy mix is serving the economy well, as evident in the containment of inflation, exchange rate stability, and reserves growth.

The authorities should continue the priority task of completing the pending legal and institutional reforms of the financial system. In that connection, I welcome the intent to ensure an orderly restructuring, privatization, or closure of the now dormant state-owned commercial and development banks. Regarding the informal money exchanges and the Hawala system, I agree with the staff that such conduits for financial intermediation are likely to persist even after a fuller development of the formal banking system. However, it is puzzling that, in the main report, the staff appears to identify such informal money transfer mechanisms as unique to the Middle East. Yet, earlier staff studies as well as Box VI.4 of the background paper make clear that equivalent informal transfer systems are operating worldwide under various names and forms. It is important to stress that the concern here is only over the informal mechanisms since the word "Hawala" is also used in the region for the regular process of financial transfers through the formal banking system.

The staff has rightly stressed the economy's unfortunate reversion in recent years to major dependence on opium production. This development is indeed a major concern for both the transparent functioning of the Afghan economy and the damages that opium addiction inflicts within and outside the country. Reversal of this trend is thus vital for all concerned. In that regard, I fully share the staff's view that success of any eradication program is contingent on an accompanying intensification of efforts to develop viable alternatives. Specifically, suitable economic development is essential to ensure alternative livelihoods and improved security for the large proportion of the rural population currently dependent on opium production. I agree with the staff that, in the absence of a well-conceived program, the country may well slide into a downward spiral of corruption and violence centered on the illegal traffic in opium.

Mr. Mirakhor has rightly stressed the importance of continued international support for Afghanistan as the country is facing large current payments deficits with little scope for either a reserves drawdown or non-concessional borrowing. In that connection, I am encouraged by the authorities' success in obtaining debt cancellations from several creditors. I also welcome the continued efforts for regularization of relations with all creditors. I agree with the staff that development of capacity for effectively tracking and managing the external debt is a priority. I am, therefore, encouraged by the establishment of the debt management unit. Regarding the existing de facto restriction-free exchange and payments system, I welcome the authorities' intent to move on to a de jure system with the requisite legal and regulatory framework.

Finally, it should be underscored that the progress that the ATA has achieved essentially amounts to an improvement in the country's ability for effective use of resources in a post-conflict context. Going forward, continued international support is clearly critical to realize the broader goals of the National Development Plan. It is essential, therefore, to sustain donor interest in the country's development effort. Indeed, the staff has rightly identified any flagging of enthusiasm in that regard as a major risk for the economy's prospects. Regarding the Fund's involvement, I agree that a good starting point at this stage would be a closer association with the authorities in the context of a staff-monitored program. Given continued progress toward an adequate track record, this should in due course lay the basis for a possible Board consideration of a program supported under the PRGF arrangement. All such prospects are contingent, however, on an assurance of adequately secure conditions, which also is a matter dependent sizably on the will of the international community. Indeed, whether for improved security or for the other crucial elements of access to concessional aid and eradication of opium production, further progress remains dependent on the continued willingness and perseverance of the rest of the world to share in the efforts to restore peaceful and stable conditions in Afghanistan.

With these remarks, I wish the authorities success in meeting the daunting policy challenges ahead.

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

We welcome this opportunity to discuss this thorough Article IV consultation report with Afghanistan, which is the first in more than a decade. The Afghani authorities are to be commended for their substantial achievements thus far in economic stabilization and capacity building. The staff are also to be commended for the critical technical assistance they have been providing to the country. The challenges facing Afghanistan are enormous, and addressing them will require perseverance in reform implementation and institution building, as well as in donor support. Our comments will focus on these challenges, particularly the need to sustain growth and address the high dependency on opium production, and to make further progress in building capacity in the fiscal and monetary policy areas.

It is heartening that Afghanistan's GDP grew at a high rate last year; sustaining solid growth is important to reduce the pervasive poverty and improve the highly unfavorable social indicators. While this outcome was underpinned by improvements in the security environment, the favorable weather conditions, the stabilization efforts, and donor-financed projects, it has also been supported by the recovery of opium production, which is ironically contributing to poverty reduction in addition to financing balance of payments needs and investment activities. This unfortunate dependence on opium production underscores the need for sustained donor financial assistance to help create alternative livelihoods to poppy producers, including through the rehabilitation of the infrastructure to support legitimate private sector activities, and the provision of social support. Enhancing security is also key to a shift in production away from opium, since it is mostly cultivated in areas where the rule of law is lax. In addition to advancing the political process, improved security would also require providing demobilized ex-combatants with legitimate sources of income.

Maintaining the focus of public expenditure on priority areas and enhancing its effectiveness are essential to meet the above challenges. In this connection, we support the authorities' strategy to direct available resources to infrastructure rehabilitation, social support, and improving the functioning of the basic institutions of the state. To enhance the effectiveness of this spending, it would be critical to put in place a modern system of public expenditure management to strengthen the monitoring and control of provincial expenditure. In this connection, we welcome the recent improvement in expenditure reporting to the central government and urge the authorities to redouble their efforts to introduce an effective system to ensure transparency and proper accounting of provincial revenue, a timely transfer of this revenue to the central government, and an adequate assessment of the provinces' expenditure requirements. It would also be important to channel through the budget all donor assistance, including for reconstruction and humanitarian assistance, with a view to enhancing coordination of domestic budget planning with donors' financing agenda, and fostering a sense of ownership in the development process.

It is important that the "operating budget" includes all priority recurrent expenditures, in particular pressing social expenditures in the health and education areas, and for social protection. The operating budgetary financing gap tends to be given particular focus by donors in assessing the "pressing" financing requirements (as opposed to longer-term needs). In this context, a special effort needs to be exerted, including by the World Bank, to make a thorough assessment of the priority recurrent expenditure requirements at both the central and provincial levels, so as to convey as complete a picture as possible on the real "operating budgetary gap." In this connection, a more judicious classification of operational and development expenditures is key to help improve fiscal analysis and identify priorities. As it stands, the development budget includes an amalgam of recurrent expenditures in health, education, security, and social support, in addition to capital investment projects with little prioritization or sense of the relative urgency of the different items. This could contribute to a lulling impression that all urgent recurrent expenditures are fully covered once sufficient grants are obtained to finance the operational budget gap. We note with regret the substantial underperformance in the development budget in the first half of FY2003/04, which was due to a large shortfall in donor support, as highlighted in Mr. Mirakhor's helpful statement. We would welcome the staff's comments on ongoing and envisaged efforts to better assess and prioritize recurrent expenditure requirements.

Making progress in civil service reform is essential to ensure an adequate delivery of public services while controlling the wage bill. An important priority in the period ahead is to offer adequate salaries to attract and retain capable personnel. In this connection, we agree with the approach of offering additional salary allowances to specific key positions, rather than a generalized public salary increase. The authorities are also encouraged to establish accurate payroll accounting, as well as eliminate unnecessary and "ghost" positions. Divestiture of public enterprises, which are largely non-functioning, would also be important to avoid the need for budgetary support and to allow the state to focus on its core functions.

Enhancing revenue mobilization is crucial to gradually reduce the large dependence on foreign assistance. In this connection, we welcome the new simplified customs schedule and urge its implementation as soon as possible. The reform of the tax code and the intended large taxpayer unit should also help raise revenue within a well-targeted and streamlined approach that is compatible with the country's limited implementation capacity. Expectations with regard to increasing the reliance on domestic revenue should, however, be realistic. As the staff indicate, Afghanistan will remain dependent on donor support in the coming years. It would therefore be important to ensure adequate financial support based on a rigorous assessment of pressing expenditure needs, and to continue to provide it in the form of grants in view of the country's extremely limited capacity to service external debt.

With regard to monetary and exchange rate issues, we congratulate the authorities for the successful launch of the new currency. Enhancing credibility and maintaining tight monetary control, including through continued strict adherence to the "no-overdraft rule," will be essential to preserve the commendable gains achieved in sharply reducing inflation and stabilizing the currency. We find the authorities' approach to limit foreign exchange interventions to smoothing short-term fluctuation, while not resisting persistent market pressures, appropriate.

To enhance the ability to implement monetary policy, as well as to mobilize resources to finance private sector investment, it would be essential to develop the financial sector and put in place an adequate regulatory and supervisory framework. In this connection, we welcome the recent licensing of three new (foreign) banks, as well as the establishment of a supervision department in the central bank. It is important that supervision capability be developed and made flexible enough to provide adequate oversight of informal "Hawala" operators who will continue to play an important role in the financial sector. With regard to state-owned banks, which are largely non-operational, we concur with the view that they should reapply for banking licenses to ensure their viability, or otherwise be dissolved in order to avoid an accumulation of quasi-fiscal liabilities.

Finally, we would like to reiterate the need for continued adequate external assistance for Afghanistan to help it meet the above challenges. The Fund should continue to play its vital role in providing technical assistance, and be prepared for a closer involvement in the context of a PRGF-supported program, as noted by Mr. Mirakhor. The authorities have demonstrated a commendable track record, and the country is in dire need of assistance and for a program that would guide policy implementation in the period ahead and provide a framework for donors' support.

With these comments, we wish the authorities success in meeting the difficult challenges in the period ahead.

Mr. Ondo Mañe submitted the following statement:

We would like to thank the staff for the comprehensive paper, and Mr. Mirakhor for his helpful and informative statement. It is encouraging to read about the significant progress being achieved in many areas, as Afghanistan emerges from a protracted conflict period, which has been detrimental not only to its economy, but also to human skills development and basic infrastructure. This situation also led to a huge refugee problem and deep poverty. Most recently, with the assistance of the international community, the authorities have taken bold steps to reverse the negative trends that have affected the country's development. In particular, efforts have been made to rebuild institutions and to implement sound economic policies, which have made possible the recovery of the Afghanistan's economy.

A successful introduction and completion of the currency conversion in early January 2003, associated with sound monetary and fiscal policies, helped achieve progress toward low inflation and the stability of the exchange rate. Measures taken concerning the adoption of new financial legislative sector legislation and the granting of autonomy to the central bank are all steps in the right direction, and contribute to the restoration of confidence in the economy. As noted in Mr. Mirakhor's statement, the private sector has started to play its role in economic activity and the building of infrastructure.

However, these positive developments remain fragile. Therefore, given the risks associated with Afghanistan's recovery, intensified efforts are needed to restore adequate security in the country, including in the provinces to allow the implementation of the ongoing reforms and projects, the resumption of the private activity and necessary utilities, and the attainment of a sustained and broad-based economic growth. Particular attention is also needed to address the issue related to the reemergence of the opium production in the informal sector, mainly through a development of alternative livelihoods for farmers in place of poppy. We welcome the authorities' commitment to sound economic policies and for efforts to address the challenges related the main obstacles to development, peace consolidation, economic reconstruction and to reduce poverty.

To achieve a sound and broad-based economic growth over the medium-term, improved security environment and the consolidation of political stability will be indispensable to help the country develop a private-sector-led economy. In addition, continued and adequate technical and financial assistance from the international community will be crucial to help Afghanistan in the pursuit of the implementation of its heavy agenda of reforms. However, with a predominately-agricultural economy subject to frequent natural disasters, the diversification of economic activity is required to help mitigate the effects of exogenous shocks.

Fiscal Policy

As the experience of post-conflict countries shows, putting in place a coherent and consistent budget in a short span of time is challenging. It is encouraging to note that the authorities have been able, thanks to their adherence to a "no overdraft rule" to restore fiscal discipline, accountability and transparency. However, more efforts are needed as regards revenue mobilization. In this connection, we welcome the strengthening of tax policy and administration and the putting in place of large taxpayer unit by the end-2003. On the expenditure side, we welcome the progress made in improving fiscal management, in particular fiscal management of the provinces and the monitoring of the development budget. The progress also achieved in the consolidation of government bank accounts to enhance efficiency in the management of treasury funds is encouraging.

To address the still remaining weaknesses, further progress in the civil service reform will be needed. Concerning the restructuring of the state-owned enterprise sector, we would encourage the authorities to give consideration to the closure or divesture of nonfunctioning enterprises only through an open and transparent process, and when conditions are warranted.

National Development Budget

The success of the reconstruction efforts lies in the continued and good coordination of donor support. It is essential that in light of the constraints and priorities confronting the authorities that sufficient resources are allocated in the areas required, mostly for infrastructure, rehabilitation, health, social protection, assistance to refugees and education. The expected assistance package for security and training of new police and conscripts of the Afghan National Army, logistics for upcoming presidential elections would be critical in this critical reconstruction process. We encourage donors to contribute, according to their pledges. As stated in Mr. Mirakhor'sstatement, this would "help ensure that the development program can be undertaken on the scale and pace required."

Fund's Role in Afghanistan

We very much support the active role played by the Fund in terms of providing advice and technical assistance. Fund technical assistance must be well targeted in specialized areas related to currency conversion, financial sector and tax legislation, and the strengthening of statistics capacity. Despite the many difficulties facing Afghanistan, as a post-conflict country, we see merit in the authorities' readiness to have a closer Fund involvement in Afghanistan in the context of a PRGF-supported program to provide the authorities with a framework for policy discipline and credibility. This is particularly justified, in light of the authorities' strong commitment to implement sound policies and the need to mitigate the prevailing constraints and risks to the country's recovery and development. Finally, we strongly believe that the international community should respond to the expectations of the population and thus support Afghanistan in its reconstruction efforts.

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

Mr. Yagi and Ms. Sekine submitted the following statement:

General Comments

We welcome this first Article IV Board discussion since 1991. We appreciate the staff's excellent report as well as the background papers that clearly illustrate the current stage in the reconstruction process and future challenges. As explained thoroughly in Mr. Mirakhor's helpful statement, the Afghani authorities have made important strides during the past 18 months to reestablish the institutional framework for conducting sound macroeconomic policies and reconstructing an economy exhausted due to long years of hostilities, coupled with natural disasters. Reassuring developments were made, particularly on the fiscal and monetary fronts, as witnessed in increased domestic revenues, improved expenditure management, the successful introduction of new currency, and adoption of new bank legislations. We appreciate the staff's extensive policy advice and technical assistance that generated the above results.

The path toward economic reconstruction of Afghanistan has just begun and mounting issues loom ahead. The reconstruction process has been slow so far, due partly to the authorities' limited administration capacity as well as to low security. Increasing opium production, with no major alternative measures in place, is complicating the reconstruction process. In order to achieve sound and sustainable economic growth and poverty alleviation in the medium-term, Afghanistan will need to implement comprehensive reforms, including the establishment of a sound macroeconomic policy framework, sufficient security, development of a wider production base as a substitute for opium, public sector reform, establishment of rule of law, as well as a sound financial sector to enhance private sector development. Integrated international support continues to be essential for promoting these reforms. But more importantly, the authorities' strong commitment to restoring security and political stability, as well as to promote economic reform is key to accelerating the reconstruction process. To assist this process, revision of the needs assessment based on two years of experience would be helpful to better grasp the development needs and to formulate better strategy to tackle them.

The authorities have requested a Fund arrangement in order to provide a more detailed framework for economic policies as well as to improve confidence from donors. This chair agrees that the Fund arrangement will be beneficial in the future to promote reconstruction and the development process of Afghanistan. However, given the current limited administration capacity and fragile security situation, we believe it desirable to proceed first with an staff-monitored program (SMP). An adequate level of the authorities' capacity as well as a good track record will be prerequisites for moving on to the upper-credit tranche arrangement. We hope that the staff and the authorities will discuss carefully the time schedule toward a possible Fund arrangement, taking into account the two prerequisites above and the election scheduled for mid-2004. We support the staff's suggestion to consider extending Emergency Post-Conflict Assistance if the conditions for such assistance were present.

We broadly concur with the staff appraisal and would like to focus our comments on areas that we see as especially important.

Sources of Growth

The growing informal opium sector, estimated to be about half of overall GDP, is a large concern. Without an effective alternative production base, eradicating opium production will only lead to a loss of means of employment for many Afghanis and poverty will spread. Hence, we concur with the staff and Mr. Mirakhor that eradication should be promoted based on an extensive, long-term structural reform strategy aimed at developing agricultural options, enhancing manufacturing, and diversifying the export base. The recent pickup in agriculture, manufacturing, construction, and services as noted in Mr. Mirakhor's statement is reassuring in this regard. Paramount also will be to strengthen supervision and regulation framework to control informal activities. We hope that the authorities will maintain their strong commitment to tackle the opium problem, along with support from the international community.

Fiscal Policy

We commend the authorities' strengthened fiscal discipline and their adherence to the "no overdraft rule." It is important to strengthen domestic revenue mobilization to prepare for any future wind-down of external assistance, and we support the promotion of ambitious customs and tax reforms. On the expenditure side, further strengthening of expenditure management will be important. We also call for improvement of efficiency and accountability of donor-financed projects. Reforming the public service wage system is an important pillar of civil service reform, and we hope that this system will become a balanced one that can attract high-quality human resources and also maintain incentives for existing skilled workers. Urgent attention must be paid to enhancing local capacity in order to improve the overall fiscal discipline and delivery of public services. It is essential to enhance fiscal management and reporting of provincial governments, and to promote provincial revenue transfers to the central government. This should be achieved only through further efforts on human development and stabilizing the security situation in rural areas.

We understand that the Fund is involved in revising the process of the needs assessment with the World Bank, the AsDB, and other stakeholders. That assessment is expected to include more realistic projections reflecting the status of Afghanistan's economy and fiscal administrative capacity. According to the Mid-Term Budget Review published by the authorities this September, the cost of reconstruction is broadly estimated to be in excess of U.S.$30 billion over a five year period. Given Afghanistan's current GDP (excluding opium production) is about US$4 billion, we wonder if the reconstruction estimate is realistic. We hope that the Fund staff will look into this issue from a macroeconomic point of view.

In order to maintain fiscal discipline, it is important that all current expenditures be included in the budget. According to the above-mentioned Mid-Term Budget Review, costs for the Afghan National Army establishment and the Disarmament, Demobilization and Reintegration (DDR) programme are currently off-budgeted from the National Development Budget. We would like to ask the staff's view on this issue.

Debt Sustainability Analysis

The staff's provisional debt sustainability analysis in SM/03/52 concludes that a considerable portion of external assistance should be in the form of grants since Afghanistan's present capacity to service new external debt is limited, reflecting weak domestic revenue and external sector vulnerability. We think that this conclusion is understandable. The staff notes in paragraph 43 that Afghanistan could be HIPC-eligible, but our current knowledge is that the HIPC Initiative is only applicable to the already approved 42 eligible countries, which do not include Afghanistan. The debt restructuring for Afghanistan should be considered apart from the HIPC Initiative, within the collaborated framework among creditors including the Paris Club and the IFIs. Improvement of debt data and updating of debt sustainability analysis will be helpful in considering the possibility of debt restructuring.

Structural Reforms

To aim for private-sector led growth, a wide reform agenda should be implemented, including the development of a sound financial sector, establishment of rule of law, and restructuring or privatization of state-owned enterprises. These reforms are of a medium- to long-term nature for Afghanistan, and should be implemented in a sequenced and gradual approach depending on the capacity level of the authorities. Since Afghanistan is a land-locked country, we believe that improving the infrastructure to reduce transportation costs and establishing a liberal trade and business regulation framework will be important to enhancing Afghanistan's attractiveness as a transit route. In this regard, we support the Fund assistance on preparing laws and regulations to establish a liberal trade and exchange regime.

Turning to the financial sector, we welcome recent efforts to strengthen supervision and the regulatory framework by adopting new legislations and modernizing the central bank. We hope that the supervision of the informal "Hawala" system will be strengthened and that it will be replaced by a more formal transfer system as the financial sector develops. Donors are engaged in micro-finance assistance and it would be helpful if the staff could provide their views on how these involvements could help enhance financial intermediation capacity and develop industries in Afghanistan.

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

Ms. Indrawati and Mr. Salleh submitted the following statement:

We would like to thank Mr. Mirakhor for his comprehensive statement and staff for their well-written report on Afghanistan. We concur with the broad thrust of staff's findings and recommendations and will limit our comments to some of the key issues.

After a long difficult period, finally Afghanistan has begun to take important steps that can help them rebuild the country. While it is still early days, some progress has been achieved both in the political and economic fields. We are pleased to note encouraging progress on the macroeconomic front, in addition to accomplishments in the structural area to date, as illustrated in Box 5, for which the Afghani authorities should be commended. It is very pivotal at this stage that the international community, including the Fund, maintain their support and commitment in providing assistance, both financial and technical, to help reconstruct the Afghani economy further. Having said that, it is equally important that the process of adjustment takes into account the country's capacity constraints and political economic aspirations. Therefore, the international community, together with the authorities should prioritize their work with a view of firming the macroeconomic environment and strengthening peace, while gradually reducing reliance on external financial assistance over time.

Fiscal Policy

To achieve economic stability and growth, it is critical that the authorities place strong emphasis on efforts in maintaining fiscal discipline and improving revenue mobilization. The overperformance of domestic revenue mobilization in 2002/03, as articulated by Mr. Mirakhor in his statement, is very encouraging. Thus, the authorities' intention to finance the ordinary budget through domestic revenues by 2006, while ambitious, is not unattainable. Towards this end, the Fund should continue to remain engaged to help the authorities in the implementation of its recommendations pertaining to reforms in customs and tax areas. In parallel to these efforts, the authorities need to strengthen the central government's control over provincial finances. On a more medium-term perspective, despite the difficulties, we agree with the staff that the authorities need to begin addressing civil service issues through a comprehensive reform program in a more determined and rapid fashion. In this regard, assistance from the World Bank is most appropriate.

Monetary, Exchange and Financial Sector issues

We welcome successful introduction of a new Afghani currency which enjoyed strong acceptance by the Afghani population. The rapid pace of currency changeover was indeed remarkable considering the challenging logistical situation in the country. We share the staff's view that the current exchange regime is appropriate for Afghanistan to help absorb external shocks and vulnerability. On the monetary policy, the authorities' emphasis on attainment of price stability and enhanced confidence in the new currency is appropriate. We also welcome recent enactment of new central bank and banking legislation that stipulates the creation of an independent central bank and paves the way for functional commercial banks to be established, consistent with the needs of an open market economy that thrives on competitive environment. The authorities' intention to introduce the necessary legislation for combating money laundering and terrorist financing is laudable and we would encourage the authorities to pursue these issues expeditiously.

External Sector Issues

We welcome the establishment of a debt management unit and the authorities' efforts towards accepting the obligations under Article VIII of the Fund's Articles of Agreement. The staff have rightly highlighted the uncertain nature of the external outlook. The level of reserves need to be augmented to provide adequate cushion against potential shocks. We agree with the authorities that, given their limited capacity to service new debt, sources of financing would need to continue to largely depend on generous grants and debt relief. On the latter, while commending Denmark, China and Germany, we encourage the authorities and other creditors to continue their negotiations with a view to resolving any outstanding debt obligations in the most expeditious manner.

Economic Outlook

As Mr. Mirakhor has stated in his helpful statement, the prospects for continued economic recovery are bright, but subject to a number of risks related to weather, security as well as external assistance. Any one of these risks can only be effectively addressed with the support of the international community. In particular, the challenge of eradicating the opium industry has to be handled with strong resolve both directly, and indirectly. It requires a comprehensive program that encompasses strategies for developing alternative economic pursuits to the people as well as putting in place adequate social safety net in terms of healthcare, education, housing and other basic needs. The authorities also need to be determined in their efforts toward establishing a conducive environment necessary for private sector activity to flourish and foreign investors to establish a firm footing in the country. In this regard, we are pleased to note the essence of the country's National Development Framework which prioritizes security and human development, infrastructure, and role of the private sector. The authorities should continue to take advantage of the resources and expertise of IFIs and donor countries in carrying out these demanding undertakings.

Role of the Fund

The Fund's involvement in Afghanistan thus far, in terms providing the country with extensive policy advice and technical assistance, has been commendable. Given the situation in Afghanistan at this stage, the Fund should intensify its involvement in areas related to capacity and institutional building through its provision of technical assistance. Concurrently, staff's proposal to initiate a staff-monitored program (SMP) is an important step forward in terms of providing the opportunity for the country to establish track record. In response to the authorities' request, we urge staff to seriously look into all prospective possibilities towards the adoption of a PRGF-supported program. In this regard, preparatory work needs to be initiated by the authorities in terms of its strategy from now on. Fund's program will have an effective signaling effect to donors as well as potential investors who wish to participate in the development process in Afghanistan.

With these brief remarks, we wish the Afghani authorities success in their challenging endeavors.

Mr. Brooke and Mr. Joicey submitted the following statement:

We welcome this Article IV report and the important normalization of Afghanistan's relations with the IMF. We are also grateful to Mr. Mirakhor for his helpful statement, describing the important progress that has been made, but also the serious risks and challenges that face Afghanistan.

We broadly agree with the analysis and recommendations contained in the Article IV report and welcome the significant progress that has been made in rebuilding institutions and restoring macroeconomic stability. In particular, we strongly welcome the authorities' improvements in mobilising domestic revenues and encourage them to continue the development and implementation of their important reforms to customs and tax policy as well as advancing their actions to increase the collection of revenues from the provinces. We also welcome the substantial improvement in financial management. We have some concerns, however, about the still low provision of public services in the provinces and urge the authorities to step up their efforts in this area as, and when, improvements in the security situation and the availability of resources allow. The agreement between the staff and the authorities on a staff-monitored programme will help build on the progress made to date and will serve as an important step towards the negotiation of a PRGF arrangement.

As staff note, the re-emergence of the opium economy poses a major security challenge and an associated risk to macroeconomic stability. Consequently, we strongly share the staff's emphasis on the need for extensive programmes to eliminate poppy cultivation and to develop alternative livelihoods for farmers together with appropriate social support. In many cases it may be more effective to achieve both counter-narcotics and development objectives by mainstreaming counter-narcotics in rural development programmes. We would also emphasise that law enforcement efforts should focus on both eradication and the interdiction of traders, traffickers and processors.

We are pleased to note the successful introduction, against significant obstacles, of the new currency, the adoption of the new central bank and banking legislation, and the authorities' intention to work with the Fund on new legislation to counter money laundering and the financing of terrorism.

We welcome the indication in Mr. Lushin and Ms. Vtyurina's statement that the Russian authorities are prepared to provide generous debt relief. Like them, we encourage all donors to follow through on their pledges of support as early as possible so that reconstruction efforts can be accelerated. As the staff rightly note, however, a faster pace of reconstruction will also necessitate increased efforts to improve security and strengthen institutional capacity. We wish the authorities every success and reiterate our strong support for their reform efforts.

Mr. Andersen and Mr. Sidlauskas submitted the following statement:

We would like to congratulate the authorities with the resumption of the Article IV consultation after a break of twelve years. We would also like to thank staff for the constructive report and Mr. Mirakhor for his helpful statement.

The authorities, with the support of the international community, have made a significant progress in implementing the Bonn Agreement and recovering from the devastation caused by more than two decades of war. However, the economic and social situation is still very fragile and the political, as well as the reconstruction agendas ahead, are heavy and challenging, but still manageable if the security situation does not block the way for peaceful development. Regretfully, the latest fatal attacks on humanitarian workers proved the fragility of security in the country. Poor security seriously undermines the possibility of providing humanitarian assistance, complicates macroeconomic management and prevents reconstruction taking place in a number of provincial areas. Therefore we believe that strengthening security is not only a key factor for supporting the political process in Afghanistan, but it is in many ways the most essential precondition for the positive social and economic development. This is a challenge that the authorities and the international community must deal with.

We share the staff's concern that the financial support of international donors, which has been so critical to the recovery so far, could weaken prematurely. Therefore, it is absolutely essential that the international community commits itself to Afghanistan's development in the long-term. We believe that joint financing mechanisms such as ARTF can help to strengthen the Afghan ownership and policy transparency, and enable to meet the pressing needs of the population, particularly in the provinces. Nevertheless, a serious financing gap still exists. We note that the assistance for reconstruction has been less than what was aimed for in Tokyo in January 2002 since much of the international assistance in 2002 and 2003 was humanitarian. Consequently, more attention to long-term development assistance has to be devoted.

We welcome the authorities' commitment to the economic reconstruction, transparency and accountability, investment in the human capital and security, reliance on market mechanism, diligent allocation and management of international and domestic resources. We also congratulate the authorities' decision to apply for membership in the WTO. The economic growth has been strong, supported by, inter alia, the stabilization efforts, post-conflict donors' assistance, and favorable weather conditions. However, future growth needs to be supported by private sector investments. Therefore, efforts to promote an environment conductive for investments are crucial for future economic growth. We note the progress in establishing a legal framework for the state's social and economic development beginning from drafting the new constitution down to new regulations of the financial sector. The implementation of such new regulations will play an important role in shaping Afghanistan's development. We also concur with Mr. Reddell's emphasis on the importance of strong institutions to sustain economic growth.

Financial stability and fiscal discipline remain the key preconditions for the reconstruction and recovery. The authorities have already demonstrated their commitment to fiscal discipline by implementing the 2002/03 budget and keeping this year's budget in control, even though lack of sufficient administrative capacities constrained the execution of expenditures. We appreciate the authorities' objective to finance the operating budget from the domestic revenues within a few years time, though so far the bulk of these expenditures has been financed by donor contributions. We also welcome the efforts to improve expenditure management, as well as fiscal transparency and accountability. Attention should be devoted to provincial finances, and we are pleased to note that fiscal discipline in provinces is improving.

The introduction of a new currency is an obvious success, as well as the efforts to curb inflation. We agree with the staff and the authorities that for the time being the flexible exchange rate regime with limited management is appropriate. However, given the long road of structural and economic transformations ahead, the exchange rate should by allowed to adjust to market developments. We also want to stress that monetary expansion should be monitored carefully to ensure price stability, and we welcome the authorities' commitment to keep the "no overdraft rule."

Banking services are hardly available for the population, but a solid legal framework is being developed for commercial banking. We believe that the authorities could benefit further from technical assistance in establishing an appropriate supervisory and regulatory framework.

A sound and healthy public sector is vital in order to ensure economic growth and gain the confidence of the public. However, quite limited progress has been made so far in civil service reform and a serious lack of adequate professional capacity exists. We appreciate Mr. Mirakhor's assurance that the authorities are aware of the need to make progress in this area, and we urge the authorities to proceed with public sector reform since it is a precondition for quick recovery, reconstruction and development.

The latest UNODC report states that the poppy cultivation and opium production continued to increase this year. In a few years, Afghanistan recouped the position of a leading producer of illicit opium and accounted for 2/3 of the world's opium output. The share of the opium sector is estimated to be about half of the economy and more than 260 000 households (7 percent of the population) are involved in poppy cultivation. Therefore a significant number of stakeholders may have vested interests in the survival of the opium industry. Even though the eradication of the opium production is a challenging task for the authorities, there are examples of successful attempts in the past to ban the poppy cultivation. Moreover, the authorities made noticeable impact on the eradication of poppy in two provinces this year. Therefore no excuses should be accepted to justify a weak eradication progress and efforts should be devoted to bring an end to the unfortunate dependence on opium production. A coherent strategy to tackle the drug economy should be implemented, including the promotion of alternative sources of income for farmers, who are dependant on the poppy cultivation.

We wish the authorities every success in rebuilding Afghanistan's economy. Determination and perseverance in macroeconomic stabilization and implementation of reforms conductive to high and sustainable growth will remain challenging in any foreseeable future. A successful track record under the SMP framework would seem to be important in considering a possible future financial arrangement with the Fund.

Mr. Wang and Mr. Wong submitted the following statement:

This Article IV consultation has a special and vital meaning for Afghanistan. It signals that the country has formally normalized its relations with the Fund and with the international community after a long interruption of 12 years. This chair welcomes this important milestone. The staff has done an excellent job, especially in view of the lack of data and weak institutional capacity, We are grateful for their hard work and considerable contribution in helping the Afghan authorities to rebuild their economy. The staff report is very informative and contains valuable advice and recommendations. We broadly agree with the staff appraisal. We would like to thank Mr. Mirakhor for his comprehensive and insightful statement.

In the past 18 months, Afghanistan has made impressive progress in rebuilding its economic and political foundation from very difficult and primitive starting conditions as elaborated by staff. We commend the authorities for making significant strides in economic reconstruction with financial and technical assistance from the international community. A macroeconomic policy framework has quickly taken shape. We welcome the introduction of the new Afghan currency and the strong discipline in the conduct of monetary and fiscal policies so far. Inflation pressure is well contained and macroeconomic stability is being restored. We can see that the authorities are sensitive to the need to strike a good balance between maintaining a stable exchange rate—and thus price stability—and letting it search its equilibrium value, which is bound to change as economic activity increases and evolves at an enormous speed. We agree with the guiding principle that monetary policy should be focused on keeping inflation low in order to contribute to exchange rate stability. On the fiscal front, important reforms are now underway but many of them will take time and require strong political will to accomplish. Lack of cohesion in the fiscal system was a major concern and we commend the provincial governors for their commitment to adhere to the budget law and remit their revenues to the center. Priority should continue to be given to strengthening operations and administration.

Of the three major risks identified by the staff going forward, the re-emergence of opium production will pose a particular challenge to the authorities. Given the scale of the industry, eradicating it is wiping out half the economy, so it is not realistic to expect this to happen any time soon. However, one must also recognize that tolerating opium production is highly distortive from an economic perspective, as it bids up factor prices and imposes an implicit tax on other sectors of the economy. Moreover, as opium producers and traffickers obviously do not pay tax, the rest of the economy has to shoulder the whole fiscal burden. In this sense, opium production is actually subsidized.

Therefore, unless a tax could be imposed on the production—which implies that the industry would have to be legalized—to price in the externality and remove the distortions, the authorities must be prepared to eradicate the industry as soon as possible. The longer it is tolerated, the more other economic sectors will be suppressed, and the harder it will be for the authorities to eradicate it in the future. Over the past two years, we are glad to see a rapid recovery in other industries. Carpet makers, for instance, are returning to the country. Premium export crops have shown strong growth. Many other sectors, such as construction, are also starting to boom. Efforts should be intensified to identify other sources of sustainable growth, including the exploitation of oil and natural gas reserves. And it is in the interests of donor countries to aid this process—as the Afghan authorities take a more proactive approach to curbing opium production, the resources required by donor countries to reduce supply at home would be less.

Since the establishment of the AIA in 2001, my authorities have signed agreements on economic and technical cooperation with the Afghan authorities, through which China is committed to providing financial and technical assistance on a number of infrastructural projects. We look forward to developing a close relationship with the Afghan authorities in the future. And we call on donor countries to continue to assist Afghanistan both financially and in terms of technical assistance, and to maintain dialogue with the authorities.

On the role of the Fund, the staff has been providing timely and invaluable policy advice and technical assistance to Afghanistan. The Afghan authorities have, in turn, demonstrated their commitment to pursuing sound policies and tough reforms despite extremely difficult circumstances. This chair believes that it is important for the Fund to firmly engage the authorities on the right policy track. A staff-monitored program would be a useful first step in this direction. Given the useful catalytic role and signaling effect of the Fund, we feel that it is desirable to move to a PRGF-supported program as soon as possible to help the authorities consolidate their achievements and stay the course of strong policies.

We wish the authorities success in meeting the challenges ahead.

Mr. Mirakhor made the following additional statement:

I have a few comments to make:

First, I wanted to reiterate my authorities' satisfaction and gratitude for the work of the staff. They have produced an excellent report. I cannot pay the staff a greater tribute on their background paper than to recall Mr. Lushin's and Ms. Vtyurina's comment, which called the SM/03/135 " a manual on how to build an economy.”

As indicated in a number of colleagues’ statements, the authorities have made significant progress, but the gains, as Mr. Ondo Mañe suggests in his preliminary statement, are very fragile. In this regard, I can only repeat the comment in Mr. Yagi's and Ms. Sekine's statement indicating that the "economic reconstruction of Afghanistan has just begun and mounting issues loom ahead."

The staff have been clear on the sources of these fragilities and have identified three major risks, i.e., security, opium production, and the premature weakening of donor support. The Board usually focuses its attention on how manageable risks are. Mr. Costa and Mr. Le Fort have added a fourth risk in their perceptive preliminary statement on the vagaries of the weather. In paragraph 5 of their statement, they suggest ways of trying to mitigate this risk. These risks are very interdependent.

The first and the most important risk is the security question. Mr. Andersen and Mr. Sidlauskas suggested that security is the most essential element for positive social and economic development. They pointed out that the reconstruction agenda is challenging, but manageable, if the security situation impedes peaceful development efforts.

Mr. Misra stated that restoration and maintenance of stability in Afghanistan have global implications, and he is correct. The international community should ensure that the security blanket is extended beyond Kabul to cover all of Afghanistan so that both economic and social developments could progress. To this end, the U.S. leadership and the participation of the international community in galvanizing international efforts on a very broad and comprehensive scale, for which my authorities are immensely grateful, have been instrumental. Currently, the international security forces can extend beyond Kabul. As you know, a new U.S. package of assistance has targeted US$600 million for the training of 19,000 people for the police force and the Afghan national army. This may be a crucial step to ensure that security is established in Afghanistan. The risk of security could be considered manageable, depending on the extent to which the international community would continue to support the Afghan's efforts in this process.

The second risk is the opium production. Mr. Misra suggested that the risks from the abrupt eradication of opium production should not prevent the authorities from attempting to take actions to eradicate opium. However, without security, it is difficult to ensure an eradication of the opium production. Mr. Kanaan and Mr. Sakr also noted that there is some overlap between opium eradication and security, and suggested that enhancing security is a key to a shift away from the production of opium.

The question remains that between now and the time when eradication takes place, what should the Afghan authorities do? On this issue, Mr. Wong and Mr. Wang stated that there should be ways to tax this product. The question is how can the authorities find possible ways to tax opium, which is estimated at export value of US$2 billion, without actually legalizing it. Perhaps FAD could provide a kind of technical assistance that could allow taxation of this product, at least for the short period of time, until ways and means for substitute products are found. The main point in Mr. Wong's and Mr. Wang's statement is that social services provided by the government are subsidizing opium production.

There are approximately 260,000 households that are engaged in the production of opium. If estimated that about four people in each of those households are directly engaged in this activity, this would imply that roughly one million people are involved in this business. When in Afghanistan, we were told about a substitute product called saffron. As my colleagues, who are familiar with this product, know, it is a very low-weight, high-value export commodity that can be produced in the same areas with same weather conditions under which opium is produced. There were also discussions about growing flowers for exports in some of those regions. These products can provide hope that it is inconceivable that, in the medium term, substitute products can be found to replace opium.

Yesterday, the *Wall Street Journal* reported on the front page that Bangladesh earns US$2.4 billion in export from the textile production from imported cotton. The textiles are exported to a major market, the United States, but Bangladesh does not enjoy the privileges of MFN. Afghanistan can become a major producer of cotton and other textiles without much difficulty because, in the past, it has been a major producer and it also enjoys privileges of MFN as well as a status parallel to MFN in European countries. Again, this possibility is not inconceivable, given international coordination, since the narcotics situation is an international problem and the difficulties go beyond the borders of Afghanistan. It is a problem that requires a global approach, and, given an international coordinated effort, one is confident that this problem can be eradicated in the medium term. Therefore, this second risk could be considered manageable with the international community's willingness and efforts to help address the problem.

The third risk is the problem of donor fatigue in trying to assist in addressing Afghanistan's hardships. As Mr. Al-Turki suggested, progress in all areas of social and economic development depends to a large extent on the continued perseverance of the international community. As Mr. Ondo Mañe suggested, the success of reconstruction efforts lies in the continued and good coordination of the donor support.

In conclusion, there are risks but, provided there is international support, they are manageable. Therefore, Afghanistan is no worse off than many other post-conflict countries that have come to this institution, have requested a PRGF arrangement, and have been granted the opportunity to work within that framework. Although some colleagues suggested that perhaps it is too early for a PRGF arrangement and that grants would be preferable to loans, the advantage of a PRGF arrangement, as opposed to grants, is that it provides a medium-term framework for policy discipline and for the coordination of donor support. Within such a framework the authorities can address the social and economic development problems of Afghanistan with the help of the international community.

I would like to repeat my own and my authorities' gratitude for the help of all the functional departments of the Fund, as well as the Middle East and Central Asia Department for the assistance they have provided to Afghanistan. Lastly, the authorities have agreed to the publication of the staff report.

Mr. Misra made the following additional statement:

We have already described in detail our comments in our preliminary statement, but since some important issues have come up, particularly in Mr. Mirakhor's description of the issues that need to be stressed, I will make some further comments.

The staff report, let me reiterate, is excellent. The only issue where I have a little doubt about is that the international community may not be prepared to help as much as it should because the security situation is not at its best. In fact, this should be exactly the opposite for Afghanistan, since its government is trying its best, as the staff report indicates, under very adverse circumstances, so all the support that they need has to be given over a longer period. The authorities can act with a long-term view, or even a medium-term view, when they are assured that support will be coming. Without that, I do not think they will be able to succeed. From that point of view, I think we need to emphasize that the support, financial, physical, and from every other aspect, should be made available to Afghanistan.

One point that I would like to make is that Afghanistan, in additon to the multilateral aid that we are thinking of, gets a lot of bilateral aid, for example, the U.S. support Mr. Mirakhor mentioned.India is another country which has been giving bilateral assistance, and I think will continue to do so. India and Afghanistan have already excellent relations so, I need not point out the kind of bilateral aid andsupport that has been given. This must be taken into account in the matrixes, so that we have the complete picture. I would request the staff to also have data collected on all the bilateral aid and the areas in which it is coming from.

The authorities have done an excellent job, and there is absolutely no doubt about that. But, there are socio-political implications if reforms are being undertaken at once, particularly when the government is finding it difficult to manage the security, the political, and the societal situation. Even though Mr. Mirakhor has agreed that the government would be carrying out all the reforms, it is our view that the emphasis at this juncture should be on stability, and there should not be a great deal of emphasis on all the reforms taking place at the same time. It will be important to sequence the reform agenda so that the authorities can implement it, and the capacity is not overloaded. If the reforms in all the area bring a lot of opposition from vested interests and nonvested interests, we will be putting them on a much more difficult track, so I would request that we look at how we sequence the reforms so that the reaction is not excessive.

In some areas they are basically back reforms that there cannot be reaction, but in several areas there can be reaction, particularly in the fragile situation. On the opium front, I saw some of my colleagues smiling when Mr. Mirakhor talked about a tax within the framework of ban or eradication. If we are looking at a million people directly engaged in narcotics production, there must be a million more who are indirectly engaged in trucking and other related activities. So, obviously, we are to find a solution and an alternative employment opportunity. I am saying this with some hindsight, if you can permit me a distraction. I was an administrator of a particular district in the 1970s where exactly the same situation was prevailing, in my country, on the Burmese border, and it was one of my jobs to destroy poppy fields. I recall that whenever we destroyed the poppy fields, the men vanished, once they found out we were coming, but the women cried. I remember that, because obviously they had no other avocation, and no other means of sustaining their children. So, therefore, what is suggested about saffron, I think needs to be looked at very carefully. From that point of view, with the World Bank support, ADB support, or any other technical aid, we should be looking at alternatives. I am not too sure about cotton as an alternative crop because all the neighboring Central Asian countries produce a lot of cotton and, Afghanistan's outlet is extremely poor, the transportation is poor, so it would be difficult for the cotton to be harvested.

So, I think from that point of view, an alternative avocation of different varieties of saffron cannot be the only answer. It has to be thought of, and the faster they find the answer, the better.

Our experience, not only in our country, but in every country wherever a blanket ban is imposed, is that there is a tendency for the activity to go underground. And, we should be aware of this. And should take care that while we impose a ban, the activity does not go underground, that part of the activity takes place, but the international community, or for that matter the authorities in Afghanistan do not know about it or cannot control it.

So for the medium term and the intermediate stage, what Mr. Mirakhor has suggested may be an excellent alternative. In what fashion it has to be transacted, I am not too sure, but some technical expert can study in what fashion a commodity which is not wanted and which is banned can be taxed. I think it is a good suggestion that he has given.

Mr. Al-Turki stated that the main concern about the introduction of taxes on opium was that it would legitimize the activities in that field, which no one would want to see. Mr. Lushin and Ms. Vtyurina's comments on opium production were very constructive. His chair would like to join them in calling on the international community to help Afghanistan deal with the narcotics issue, and not to let it follow the path of some other countries where the consequences of unimplemented promises had truly proven to be grave. His chair also joined Mr. Lushin and Ms. Vtyurina in urging the staff to work relentlessly to emphasize the importance of alternative crops to farmers and to prepare a needs assessment as soon as possible.

Mr. Mirakhor made the following additional statement:

To avoid any misunderstanding, I would like to comment on Mr. Misra's very useful intervention. First, singling out the United States is not an attempt to understate other bilateral contributions, such as those of the EU or Japan, which have been enormous. It is just to recognize the immense contribution that the United States and its leadership have made and the strong commitment they have shown in the reconstruction of Afghanistan. Bilateral contributions have certainly been very important. My authorities recognize particularly the contributions of India and the other neighboring countries in the region and do not underestimate, or downplay, bilateral contributions.

Trying to rebuild and reconstruct Afghanistan is a truly an international effort. My authorities are the first to recognize this aspect of the process. In response to the legitimate point that the emphasis should be on stabilization, a proper sequencing of reforms, and prioritization is precisely why my authorities are requesting a PRGF arrangement. Within that framework, reforms can be prioritized and sequenced properly.

On my comments regarding cotton, I was not suggesting cotton production for export, but as an initial process that could provide inputs to textile manufacturing to allow Afghanistan to become manufacturer and exporter.

On the question of taxing the narcotics business, Mr. Wang and Mr. Wong made an economic argument in the statement. The fact is that the market value of opium exports is estimated at US$2.4 billion and that this activity is taking place anyway. Until a properly coordinated and comprehensive program is established, this activity is imposing costs on social services in Afghanistan, and will continue to do so.

There are many ways to tax secondary income from narcotics activity even if the primary income cannot be taxed. Some VAT could capture part of this kind of activity without legitimizing it. In addition, gasoline and other products could be taxed without any attempt of legitimizing the narcotics business. The government needs financial resources, and narcotics activity is continuing. Without a comprehensive program that will also help a social safety net to take care of the families that are involved in narcotics production, no eradication plan would be successful.

Mr. Misra replied that he did not mean to imply that the United States had not contributed significantly to Afghanistan, but rather he wanted to suggest that bilateral aid should be brought into the process. It was not important whether India's bilateral assistance was mentioned. The objective was to find the data gaps in the budgetary framework. It was quite possible that if the staff had not taken bilateral aid into account, they would be duplicating some efforts. If bilateral aid to Afghanistan were taken into account by the staff, then there would be a clearer picture of the needs and the future path to follow.

The Acting Chair (Mr. Carstens) stated that Mr. Al-Turki's point was well taken. If narcotics production was an illegal activity and those involved were caught, they would be taxed at full rate of 100 percent: not only would the opium be destroyed, but the proceeds of that sale would be confiscated. Therefore in a way, that activity was already fully taxed. The most difficult issue was that declaring narcotics production illegal would make collecting "taxes" extremely difficult and there was very little chance of that happening. If narcotics producers and traffickers used the transportation system to move opium, they should be taxed, but that was a difficult issue.

Mr. Mirakhor stated that, on the issue of the 100 percent tax for the narcotics business, nobody was paying the 100 percent tax because if those involved were caught, the penalty was death. The problem was that security was not extended to the areas where opium was produced. There was a need for international efforts to ensure that for the time being, until security was extended to areas where a 100 percent tax could be imposed, there ought to be a way of not allowing narcotics production to be subsidized. At least, from a theoretical point of view, it was sensible that a product, such as opium, with the highest value marginal product imaginable, should not be allowed to impose costs on the society.

The staff representative from the Middle East and Central Asia Department (Mr. Bennett), in response to questions and comments from Directors, made the following statement:

> I will address some of the questions raised in the preliminary statements. On the opium issue we just discussed, Mr. Reddell and other Directors asked whether there were lessons to be learned from the experiences of other countries concerning narcotics control. An analysis of other countries' experiences would be highly relevant in designing opium eradication programs in Afghanistan. We have not undertaken such an analysis in the staff report not because we did not consider it important, but rather because with our limited resources we had to focus our priorities on what was going on in Afghanistan and on bringing that to the attention of the Board and the world as we are doing in this meeting and as we did in Dubai in September.
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> Narcotics control is not an area of expertise for the Fund or an area in which we have traditionally been involved in through our programs, even with countries that have narcotics related problems. However, the narcotics industry has loomed large in our staff report on Afghanistan because of its

sheer scale and macroeconomic importance to the economy, equal to nearly half of the GDP. By contrast, the narcotics business in Colombia and Bolivia, although large in absolute terms, is relatively small in terms of GDP, approximately in the order of 3 to 4 percent of GDP, so it is quite a different order of magnitude altogether.

Narcotics is also a sensitive subject that country authorities are typically not keen to discuss with the staff. This is why the Afghan authorities are to be commended for their willingness and desire to bring this matter to the forefront of the discussions with us and other IFIs and agencies. The authorities fully realize how dangerous the narcotics industry is to the stability of the country. The World Bank and UNODC will be discussing possible strategies to address the narcotics situation in December. But until then, we can draw on some lessons learned from other countries' eradication efforts. In Bolivia, for example, where there has been an ambitious eradication program, we have also seen that eradication can bring economic hardship, social unrest, and political instability. This highlights the need for the program to develop alternative livelihoods.

In answer to another question, let me emphasize that there are no alternative crops that can directly compete with the poppy, which is too profitable for any other crop to displace it purely on competitive grounds. Therefore, poppy production cannot be eradicated by the carrot alone and must also involve plenty of stick. Policing and the enforcement of security is essential to successfully eradicate the poppy in Afghanistan.

There was a question raised in the preliminary statements on what Afghanistan's export options are over the medium term. This question is well answered in Mr. Mirakhor's statement, which mentions that Afghanistan is very rich in natural resources. There are unexploited reserves of oil and gas, iron, copper, lapis lazuli, emerald, and gold. There is also a possibility for other more traditional industries, such as carpet weaving, to contribute to the export market as well as the potential for agricultural exports of fruit, raisins, and walnuts. Afghanistan also occupies an important position in transit trade among the neighbors of Iran, Tajikistan, Turkmenistan, Uzbekistan and Pakistan. However, all of these export options will require substantial investment to reach their potential.

Mr. Reddell raised a point about the importance of institution building. Let me stress that the authorities and the staff are very much aware of the need for sound and strong institutions to underpin Afghanistan's stability and growth. The Fund has been engaged in institution building along with other IFIs and agencies, each according to their expertise. As has been documented in the background paper, the Fund's first priority was to help the Afghan government establish a ministry of finance and central bank, where much work has been done. The Fund will continue to work on institution building in the period ahead.

On fiscal policy and financing issues, there was a question raised on the customs reform package. My understanding is that the customs reform package was approved by the cabinet six weeks ago and is awaiting the president's signature. There was a question of why the Afghan national army and the Disarmament, Demobilization and Reintegration programs were off budget: the Afghan national army's wages and salaries are included in the operating budget but the equipment side is not included in the operating budget. Although it would be preferable for these programs to be transparently included in the development budget, one has to bear in mind that these programs are sensitive because of their military nature and that they are funded by a number of key donors, so the off budget treatment is perhaps understandable.

Another fiscal policy question related to the efforts to prioritize recurrent expenditures in the budget. An important improvement of the present budget over the previous one was the inclusion of a process according to which line ministries were asked to submit competing expenditure bids to the ministry of finance to help the ministry of finance prioritize overall spending at the beginning of the fiscal year.

There was a question on the needs assessment exercise currently underway and the relationship between the figure of $30 billion cited as an earlier estimate for reconstruction in relation to Afghanistan's GDP of only $4 billion. Of these two figures, it is the latter figure on GDP which is out of line. A GDP estimate of only $4 billion is well below the level necessary to prevent widespread poverty in a country of approximately 20 million people. For the proposed program of reconstruction and development to be called a success in any way, it must put Afghanistan on a growth path toward a level of GDP substantially higher than $4 billion. Against a larger figure for GDP, a program costing $30 billion over five years might not seem quite so disproportionately big. Whether $30 billion will indeed be what is needed is yet to be determined. A new needs assessment exercise is currently underway and is expected to be finalized before the donor conference scheduled for mid-February 2004.

In regard to the monetary policy and financing issues raised in preliminary statements, there was a question about the consistency between the observed path of the exchange rate and the stated policy of exchange rate flexibility. Monetary policy has been guided so far by an informal ceiling on the growth of currency in circulation, which is set according to an approximated inflation target. But in the present circumstances of rapid economic recovery from a disaster zone, with profound structural changes underway in the context of an unknown level of dollarization, the demand for money is likely to be unstable. Other monetary indicators must also be kept in the picture, and of these indicators, the exchange rate is the most important early measure of the tightness or looseness of monetary policy.

In the early stages of currency reform, there is a case for avoiding undue volatility in the exchange rate. This is why the central bank is timing its auctions of foreign exchange, which are designed to keep money growth within the target, with occasions of weakness in the exchange rate. The result has been the observed stability in the exchange rate. However, we have been assured by the Governor that if there should be persistent exchange rate weakness, the central bank would not attempt to resist this through excessive sales of foreign exchange. The description of the present regime as a "lightly managed" float remains valid.

There was also a question regarding the involvement of donors in micro finance. The recovery of financial intermediation in Afghanistan is just beginning with the passage of the two key banking laws. Private sector growth in a country like Afghanistan will likely come mostly from small-scale activity, and micro finance institutions have proven to be helpful in fostering this type of growth. In Afghanistan, a micro finance bank with the participation of the Aga Khan Bank, the IFC, and the Asian Development Bank, is currently being established. That bank has attained a license and is expected to become operational in the near future.

Finally, on the role of the Fund, the main purpose of the proposed staff-monitored program (SMP) would be to help develop Afghanistan's policy making capacity so it can undertake increasingly ambitious programs in the period ahead, including possibly a PRGF-supported program in due course. This perhaps also answers the question raised by Mr. Le Fort and Mr. Costa on whether a SMP could support the National Development Framework, particularly the third principle that investing in an institutional framework and human capital is essential for aid to be effective. The development of human capital, both generally in institutions and particularly in the immediate future in the main ministries of financial institutions, will be recognized in the staff-monitored program and successor programs as a key factor for development.

The staff representative from the Policy Development and Review Department (Mr. Fisher), in response to Mr. Yagi and Ms. Sekine's question on HIPC eligibility, confirmed that Afghanistan is currently not eligible for the HIPC Initiative. At the time the Board established the eligibility list, countries that were in protracted arrears to the Fund were not considered for eligibility. The arrears had now been cleared, and consideration could be given at some point in the future to making Afghanistan HIPC eligible.

Ms. Jacklin made the following statement:

We welcome the return of Fund involvement, and specifically the Article IV process, to Afghanistan after a 12-year hiatus. This Article IV represents a comprehensive overview of the problems facing the Afghans in the near and medium term. Like Mr. Lushin, we appreciate the high-quality staff papers, including the one issued in September.

The authorities have faced a daunting task in the past year and a half in rebuilding economic institutions and putting in place stable macroeconomic policies. They should be commended for their achievements to date. The introduction of the new currency is the most visible of these achievements, and the Afghans have also made strides in fiscal and monetary areas. Strong financial and technical support from the international community, including from the Fund, has been essential in this process. The Managing Director in his trip report this morning noted that other countries in the region are concerned about Afghanistan and believe more attention should be paid by the international community. We agree with this view.

Clearly, significant donor financing will be needed going forward in support of the Afghan reconstruction efforts. The National Development Framework and Budget provide a strategy for development, but is dependent on strong external support. Like the staff and Mr. Mirakhor, we urge the authorities to avoid debt that is not highly concessional. To this end, the United States has recently approved significant amounts of grant assistance for Afghanistan. Among other things, these funds will help the authorities strengthen their domestic security, conduct the election process, and jump-start infrastructure projects.

At present, the authorities have very few policy tools, limited resources, and even more limited technical capacity to implement complex economic policies. In the area of monetary policy, the authorities have a single tool, exchange market intervention, to try to maintain relative price stability. So far, the authorities have done a good job, with prices largely stable this year. Given difficulties in measuring money demand and the high degree of dollarization, it will take some time to develop additional tools. In the meantime, we concur with the staff's recommendation to allow some exchange rate flexibility to keep external events from directly impacting domestic markets. We welcome passage of the new banking laws.

On the fiscal side, the 'no overdraft' rule has been a useful guide, and we support its continuation. Improving revenue mobilization is a clear priority in both tax and customs. While customs revenue will remain important in the short and medium term, the government should develop plans for building a sustainable tax revenue base, including consumption taxes. We welcome the progress made in expenditure management and the plans going forward, as described in Mr. Mirakhor's useful statement. Stronger control over the civil service and state enterprises will be needed in the medium term.

On structural issues, setting up a strong legal and financial environment to support private sector growth is essential for the medium term. Taking early steps to initiate the privatization process should be a high priority in the coming year. And, maintaining a liberal trade regime is important to avoid corruption and encourage competition. We also agree with the staff's concern about the shadow economy in Afghanistan, and in particular the need to counter narcotics production and trafficking. As noted by many Directors, it is essential that other opportunities and incentives be provided to Afghan farmers to allow them to generate income in the legal economy. The U.S. assistance package will help with this process.

Turning to the Fund's role in Afghanistan, we welcome the extensive technical support and policy advice that the Fund has provided so far. We encourage further collaboration between the staff and the authorities, particularly through technical assistance to build capacity in the government and central bank. The development of a macroeconomic framework would also be useful. We therefore welcome plans to develop a staff-monitored program (SMP) next year, but we would encourage the staff and the authorities to maintain a focus on strong policy development and capacity-building. The SMP should support, and not detract, from such efforts. Looking further ahead, a PRGF-supported program may be needed late next year after the elections, if the authorities have developed sufficient institutional capacity and policy tools to implement a full-fledged IMF program. We expect that the development of a PRSP will take some time, building on the National Development Framework.

Mr. Harzer made the following statement:

The Afghan authorities have, with financial and technical support from the international community and not least from the Fund, indeed, built an impressive track record over the past 18 months in terms of sound economic management, institution building and the restoration of macroeconomic stability. This is all the more remarkable if one takes into account the quite discouraging starting point after twenty years of conflict.

The authorities——through remarkable efforts—have managed to install the building blocks of an open, market-based economy to which they are firmly committed. The successful introduction of a new currency together with the recently passed new banking laws as well as the progress which has been achieved in pressing forward fiscal reforms represent a solid institutional basis on which private sector activity can generate the growth rates needed to reduce poverty. This is important to ensure broad support for further measures aimed at the economic and political reconstruction of the country. In this context, we find the strong and quite broad-based recovery of the real sector encouraging, even though it is coming from quite low levels.

Looking ahead, it is obvious that prospects for the further economic development critically depend on improvements in the security situation and, thus, on strengthening the authority of the central government over the provinces. According to a UN-commission report, Afghanistan is currently living through the most critical phase since the beginning of the peace process. Against this background, it is all the more important that international efforts in support of Afghanistan are being continued in full since they are key for improving the prospects for a lasting peace, as aimed for by the 2001 Bonn agreement, as well as for further anchoring stability-oriented macroeconomic policies. We fully concur with the staff that it would be more than counterproductive if donor assistance were to decline just when Afghanistan's absorptive capacity is increasing. We, therefore, urge all participants to fully stick to their commitments given at the Tokyo donor conference. At this critical juncture it is, indeed, important to emphasize that Afghanistan will need sizable international assistance for several years to come.

In the same vein, we welcome the authorities' intention to aim at a closer Fund involvement in the context of a Fund program which is a precondition for debt relief from the Paris Club. We fully agree with the notion in Mr. Mirakhor's very helpful statement that starting with a staff-monitored program (SMP) gives the authorities a good opportunity to build on their strong policy track record and, with continued Fund technical assistance, establish the planning and implementation capacities needed for a successful PRGF-supported program.

Allow me to make three quick additional remarks.

First, strengthening the customs and tax administration as well as enforcing the transfer of provincial revenues to the central government will be crucial preconditions for attaining fiscal sustainability. We encourage the authorities to press ahead in these areas, notwithstanding political resistance.

Second, an efficient financial sector is key to foster private sector activity. Apart from the new banking laws, it will be essential, for efficiency reasons, to create a transparent and easily accessible payment system which could substitute, or at least complement the dominating "Hawala" system in the longer run.

Third, we concur with the staff that efforts to reduce opium production will only be successful if intensified sanctioning is combined with the provision of alternative livelihoods. The latter may require a good deal of donor support as well.

Finally, we wish the Afghan authorities the courage and endurance to proceed with the course they have chosen and the Afghan people the security, freedom and prosperity they have deserved for so long.

Mr. Boitreaud made the following statement:

At the outset, we would like to thank staff for their very comprehensive report and Mr. Mirakhor for his enlightening preliminary statement describing the important progress that has been made, but also the current risks. We commend staff for their excellent work there. We would also like to commend the staff for the excellent work done in difficult and dangerous conditions.

As far as the current challenges are concerned, we fully share the staff's view that there are three main issues which have to be tackled to allow a sustainable recovery in Afghanistan.

Governance: the capacity of the central government to control the entire country is key not only to the sustainability of the tax revenues but also to the stability of the country and the investment climate. There are also evident weaknesses in the Afghan administration which have to be addressed.

Security conditions: the recent attacks against UN representatives and NGO members show that the situation outside Kabul may be worsening, which raises a lot of concerns for the future.

Opium-Poppy culture: letting it become entrenched will lead to more violence, to a lower potential growth of the official economy in the future and, last but not least, will seriously undermine the efforts to strengthen governance, particularly in the provinces. We very much support, in that respect, the authorities' commitment to an effective eradication program, as mentioned in Mr. Mirakhor's Buff. We strongly concur with Mr. Brooke that the international community has a key role to play in terms of financial and security support in that field, as clearly explained in Box 6 of the staff report. Regarding taxation, I tend to support Mr. Al Turki's comment that taxing would probably legitimize an illegal and fundamentaly disruptive activity. There is also the risk that indirect taxation of opium could generate distortive effects that would prove counter-productive at the end.

Let me now mention a few more specific issues.

First, the macroeconomic policy: like staff, we commend the authorities for their current fiscal and monetary policy, as well as for their managed floating exchange rate system which could be backed, however, given the current uncertainties, by a larger amount of reserves, if possible of course. The debt issue is a real concern since the Russian claim represents roughly 250 percent of GDP by itself for example. Like staff, we encourage the authorities to set up a functioning debt management system within the new management unit.

Second, the structural reform: We very much welcome the announcement made by Mr. Mirakhor that, with Fund assistance, the authorities intend to put in place new legislation to counter money laundering and the financing of terrorism and that the "Hawala" money transfer system will be addressed on a case-by-case basis.

Role of the Paris Club: like Mr. Yagi, we think that the staff's comments on the HIPC-eligibility of Afghanistan may be a bit premature. It has to be discussed in-depth in the Paris Club. I have noted Mr. Fisher's explanations but it should also be recalled that HIPC was designed as an exit strategy for country with a history of successive debt reschedulings and/or restructurings. This is not the case of Afghanistan, a country which has never benefited from a Paris Club agreement, for example. In this regard, we believe that the relevance of Paris Club more "traditional" terms should first be assessed before raising the issue of HIPC-eligibility. It is indeed a complex question and we invite the authorities to discuss it directly with Paris Club creditors.

Role of the IMF:

We very much support the idea of an SMP between March and October 2004. It should be a good test of the authorities' capacity to monitor a program and could lead to an effective administrative capacity building.

We are also very much in favor of a PRGF as a successor program in the fall of 2004 after the presidential election, depending on the improvement of the political and security situation and on the results of the SMP. The SMP itself should be closely linked to a more coordinated technical assistance framework provided by the Fund.

This being said, we wish the authorities every success.

Mr. Padoan made the following statement:

Like other Directors, I would like to thank the staff for the high quality paper they have produced and for working in a very difficult situation characterized by severe data limitations. As noted in Mr. Mirakhor's statement, this discussion marks an important step towards the resumption of normal relations with the Fund and the international community. The Afghan authorities have made progress in establishing a framework for sound macroeconomic policies and beginning the reconstruction process. However, the challenges are ahead are enormous and the risks remain high.

We agree with the staff and with Mr. Boitreaud that the major risks are poor security and the limited rule of law. Restoring adequate security is a key priority and is crucial to achieving sustainability growth and private sector development.

As we have discussed at length, opium production is a serious problem and is particularly worrisome given its size relative to the rest of the economy and the risk of a pervasive corrupting influence on the country as a whole. On this issue, we share the points made by Mr. Reddell and thank the staff for responding to those points. Mr. Mirakhor made it clear in his statement that the problem of opium production is not merely a problem of reallocating resources, but is a problem of the structural transformation of the economy. That cannot be achieved without a minimum legal framework and a rule of law which forms the basic environment within which economic activity should be carried out. In this respect, I very much share Mr. Al-Turki's point that the idea of taxing an illegal activity such as opium production would almost by definition make it legal, at least in the perception of the public, and I would be perplexed if that were the way to move forward.

Regarding fiscal policy, we stress the importance of improving revenues to ensure the independence of the budget from donor assistance. In particular, like Mr. Harzer, we urge the authorities to continue their efforts to improve transfers of revenues from the provinces and to implement the customs reform. We welcome the major reforms undertaken in the fiscal and monetary front, in particular the consolidation of government accounts and the successful introduction of the new currency. We commend the authorities for the new central bank and banking law and we urge them to avoid budgetary and loss of confidence costs in dealing with the existing state-owned banks.

We also welcome the adoption of a national development framework based on sensible principles such as domestic ownership and private sector development. In this respect, we emphasize, like Mr. Le Fort and Mr. Costa, the need for investing in human capital.

Regarding the role of the Fund, we believe, like Ms. Indrawati, Mr. Salleh, and other Directors, that continued technical assistance would be crucial in building capacity. We note that there are serious constraints on closer Fund involvement. However, we assume that the staff has adequately evaluated this constraint and in this light, we support staff proposal to proceed first with a staff-monitored program (SMP). Besides providing a track record, a SMP could be useful in establishing an adequate level of capacity for a future relationship with the Fund. However, like Mr. Lushin and Ms. Vtyurina, we consider it premature to discuss a PRGF arrangement before the 2004 elections and before the preconditions for safe staff travel are in place.

Finally, we congratulate the authorities for the decision to publish the report and we wish them every success.

Mr. Cobos made the following statement:

We thank the staff for an excellent set of papers and Mr. Mirakhor for his informative statement. Afghanistan has shown strong signs of economic recovery, supported by sound macroeconomic policies, prudent fiscal policy and improved expenditure management. Nevertheless, Afghanistan remains exposed to several risks, including a diffused security situation, the opium issue and the corruption it generates, and uncertainty as to the support from the international community.

We note the commitment on the part of the authorities to press ahead with efforts to rebuild institutions after the lengthy conflict. We fully agree with Mr. Mirakhor that it is critical to restore peace and security in the short term, and that this effort ought to be complemented by the support of the international community in order to consolidate a solid base for growth and development.

In the macroeconomic front, Afghanistan has made an important start with the 2003/04 budget, drafted with assistance from the Fund. Looking ahead, it will be crucial to implement a fiscal reform that strengthens the revenue collection system and improves tax administration. We welcome the introduction of the new currency and note that monetary policy has been coherent with the fact that Afghanistan is a highly dollarized economy. We also praise the recent reform of the central bank, which should improve its operations and strengthen the supervisory capacity over the banking system.

We favor the principles adopted by the authorities to pursue its development program (NDF). This program, which enjoys strong ownership and full participation of stakeholders, aims at strengthening the institutional framework and at enhancing investment in human capital. Under these guiding principles, the authorities are seeking to engage the international community in their efforts to attain sustainable development over the long term.

The Fund's involvement with Afghanistan in the form of technical assistance and policy advice has played an important role at this critical juncture. Looking towards the future, these efforts should be complemented with financial assistance. In that regard, following the implementation of a strong framework of sound economic policies, we look forward to the Board's support for a PRGF-supported program after the Presidential elections in the autumn of 2004. We wish the authorities success in their endeavors.

Mr. Skurzewski made the following statement:

The resumption of Article IV consultations with Afghanistan after more than a decade is good news. The staff report, supplemented by earlier released documents on debt sustainability and rebuilding macroeconomic framework, presents a welcome first accounting of the challenges and risks ahead. While there are signals, in particular those illuminated in Mr. Mirakhor's statement, of the return to a certain extent of normalcy, the situation on the ground-remains grim-especially in terms of security and outside Kabul.

The authorities have so far demonstrated a strong commitment to sound economic management in a very difficult environment. The economy is showing signs of recovery, albeit from a very low level. Accordingly, growth rates have to be interpreted with caution. For a real take-off to materialize, security, stability, and institutions have to be reestablished and extended beyond Kabul. Accelerated and uninterrupted economic reconstruction efforts are crucial in view of creating political capital, allowing the ATA to consolidate and extend its authority over the whole country.

Restoration of macroeconomic stability and creation of an environment facilitating development of all sectors of the economy must be a priority in two respects. On one hand, it is needed in view of gradually reducing the reliance on development assistance in the medium term. In this regard, we urge donors and the recipient authorities to resort to grants and concessional instruments alone, in order to limit any additional fiscal burden imposed by the loans. This becomes even more important as long as the issue of external debt remains unresolved. In this respect, I welcome the declaration of the Russian authorities and look forward to a mutually acceptable agreement.

On the other hand, economic opportunities and incentives are necessary to promote a diversified economy, with a decreasing reliance on illegal activities. In particular, addressing the problem of opium and its derivatives production is a major challenge. Given that it accounts for the largest share of export earnings and nearly half of GDP, eradicating opium production would have a significant depressing effect on the economy and population. The staff is proposing to put in place programs to promote alternative livelihoods for poppy farmers. Taking into account the Bolivian experience, I wonder, however, about concrete alternatives-similarly to the point made by Mr. Lushin and Ms. Vtyurina. I look forward to the staff's involvement in these efforts, which has to be supported by the international community.

Given the opium problem, the uncertain pacification of the country, and the forthcoming elections, mentioning a possible future upper credit tranche arrangement, or even an emergency post conflict assistance, seems premature. The scenario that restrained opium production will lead to significant balance of payments needs is likely. However, requests for the use of Fund resources beyond the first credit tranche require substantial justification for the expectation that the members' balance of payments will be resolved within a reasonable period of time. Unless Afghanistan and the international community adopt a credible strategy to provide such justification, we do not currently see the conditions met for a financial engagement of the Fund. We welcome, however, the staff-monitored program and continued technical assistance, which is contributing to restoring Afghanistan's institutional framework.

The restrictive monetary policy and adherence to fiscal discipline are supportive of the reconstruction efforts. We commend the authorities for the successful completion of the currency conversion and for refraining from monetary financing. Constraining government spending by the amount of domestic revenues and donor assistance available is a sensible approach, which should help entrench principles of sound fiscal management from the very beginning. In our view, it is also important that the expected growth of the budget–given the need to address the enormous pent-up social needs–goes hand in hand with a strengthening of capacities. Technical assistance provided by the Fund to this end is most welcome. Sticking to and formalizing the liberal exchange and trade system, as intended by the authorities, will also contribute to the efforts to diversify the Afghan economy.

Reforms should rightly focus on increasing revenue mobilization, even though no miracle can be expected given the overall context and uncertain links between provinces and the central authority. We are encouraged by the recent improvements in revenue collection and increased revenue transfers from provinces to the center. Putting in place a mechanism to verify provincial revenues and expenditures must now be a priority.

I look forward to the staff's contribution to these efforts, which have to be supported by the international community to succeed.

Mr. Calderon-Colin made the following statement:

Let me join other Directors in congratulating the staff for a very comprehensive set of papers, but most importantly for the challenging task they have taken and for their performance. I also appreciate Mr. Mirakhor's always deep an insightful comments. We welcome the first Article IV consultation for Afghanistan after 12 years and hope that the new relationship between authorities and the Fund will be very fruitful.

In general, I agree with the thrust of the report, so I will proceed to do some remarks for emphasis.

The outstanding recovery of the economy is encouraging, although understandable from the very low basis from which it is starting. We coincide with the main risks identified in the report and acknowledge that further improvement will require the concurrence of many factors. Notwithstanding, we consider that progress in operating fiscal and monetary policy has been exceptional.

In fiscal policy, I would like to associate myself with the remarks made by Mr. Kaanan and Mr. Sakr in their preliminary statement, particularly with respect to the public expenditure and the operating budget. With respect to financing, we agree that for some years, Afghanistan will continue to depend on grants and concessional loans given the country's low capacity to service new external debt. We also welcome the notice from Mr. Lushin and Ms. Vtyurina regarding a generous relief of the debt with Russia. We look forward to further developments in this issue.

On monetary policy, like many other Directors we congratulate both authorities and the staff for the successful introduction of the new currency. Furthermore, the approval of a new law for the central bank, granting it independence, will be a cornerstone for the future economic stability of the country. We do consider, however, that technical assistance for the development of further monetary policy instruments is a matter of the utmost importance. Although useful by the moment, the so-called managed float or lightly managed float, could become complicated or ineffective by trying to meet two objectives with a sole instrument. Regarding the existence of the "Halwala" system, authorities should in some way take advantage of the links established already and their effectiveness and attempt to use these towards the objective of gradually establishing a more formal financial system. At the moment it will be important to understand the system and learn to coexist with it. Perhaps analysis on the "Halwala" system presented to the Board in a previous informal seminar could be useful.

We welcome the adoption of the new banking legislation. We agree with the staff on the need to strengthen capacity to adequately license and supervise commercial banks. With respect to state-owned banks, we agree with the need for qualified management but however, believe–as Mr. Lushin and Ms. Vtyurina–that their privatization should not be hasty. Progress is made in many areas in Afghanistan, but at a slow pace. Before making such considerations many other steps are pending to establish a stable and sound financial system. In any way, it would be interesting to know if the staff have any idea of possible future investors. It may be difficult to find investor–at least domestically–that include the know-how of the banking business as one of their assets, while it is also necessary to have established an adequate banking supervision system. We must say that we have nothing against foreign investment in the financial system but in this case we believe further developments still have a long way to go.

With respect to the reemergence and outstanding importance of the opium production and its spillovers to the rest of the economy, we agree with the urgency to develop ways of life for an important part of the country. This is a significant challenge since other countries' experience (some of them in South America), have not been very effective. However, lessons may be also drawn from failures, a point I believe is shared by Mr. Lushin and Ms. Vtyurina, and by Mr. Skurzewski.

We acknowledge the significant contribution of the Fund in technical assistance. Just a small point on this, perhaps I am wrong, but point IX of Annex I does not seem to see engagement in technical assistance to develop or strengthen BOP statistics, as an essential tool for economic assessment and management.

In terms of the relation with the Fund we notice that the authorities are interested in a PRGF arrangement in the future and would perhaps start with a staff-monitored program. Would eventually a post-conflict assistance program be of interest to the authorities? The staff's comments would be welcome.

To conclude, challenges are gigantic but progress on establishing a sound foundation for economic management and macroeconomic stability is promising, with an important role for the private sector. Mr. Mirakhor has enumerated some of the potential possibilities for further development of the economy. The authorities' commitment and responsibility will be, together with donors' contribution and positive developments in security, as well as a gradual reduction of the importance of opium and its substitution for other sources of growth, essential for the future of Afghanistan.

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

Mr. Faircloth made the following statement:

Like other Directors, we welcome the completion of the Article IV consultation. We also commend the authorities for their economic achievements over the past two years. These efforts will need to be sustained in the period ahead, which other Directors have already noted will be a monumental challenge. The lack of capacity in the civil service, the rising opium production, and the perilous security environment are key risks that need to be addressed, in part through the continued support from the international community.

I broadly agree with the recommendations elaborated in the staff report, and have a few additional comments about the economic infrastructure, donor assistance, and the IMF's engagement in Afghanistan.

On economic infrastructure, we agree that improving domestic revenue capacity is a vital next step. In that context, we welcome the planned tax and customs reforms, although it remains to be seen whether these will prove to be effective. Much will depend on the continued cooperation of provincial governors to submit customs revenues and the adherence to the budget law, which is by no means assured. In the final analysis, the state's long-term capacity to generate revenue will depend significantly on the peace process and the central government's ability to exert its authority, including by bringing rival factions into the process. The sharp increase in opium production is worrying from this perspective, as it complicates prospects for greater central authority and raises broader risks of corruption and an unsettled security environment. We share Mr. Brooke's views on how to make progress in addressing this difficult problem.

On monetary and exchange rate policies, notwithstanding progress in stabilizing the new currency, reports on the ground indicate that the economy is becoming increasingly dollarized. We wonder what might be done to reverse this trend at an early stage of reconstruction, given the lack of adequate policy tools. We also wonder what risks dollarization might impose in terms of economic development and stability. The staff's comments would be appreciated on these issues.

We share the views of those Directors who have underscored the need for more sweeping civil service reform. On donor assistance, we agree that it will be need to be sustained and targeted in areas that will help Afghanistan become economically self sufficient as opposed to being concentrated on humanitarian assistance. Like Mr. Yagi and Ms. Sekine, we agree that the needs assessment should be updated to formulate a better strategy to tackle development challenges. Active IMF involvement in terms of regular macroeconomic assessments and subsequent briefings with the government and donor community would help to strengthen donor coordination.

In terms of the Fund delivering technical assistance, our preference would be to focus on efforts for the formulation and implementation of economic policy advice to the government in recognition of the identified lack of capacity in the civil service.

On the question of the role of the IMF in Afghanistan, our views are most closely aligned with the views of Mr. Reddell and Mr. Lushin. We wonder whether incurring debt to the IMF is the best way forward, especially given that the weak statistical capacity and the general lack of institutional infrastructure will make it difficult for any Fund arrangement to deliver its full benefits.

We are also concerned that the staff's exposure to the country has been limited from a regional dimension. For IMF surveillance to be truly effective, more needs to be done to gather information from provinces on budgets and their linkages with the central authority's budgeting processes. However, we fully endorse Mr. Lushin's point that the precondition for safe travel is relevant.

On balance, with we believe that the timing of any Fund supported financing arrangement in Afghanistan should be carefully considered. At this stage, we can support a staff-monitored program with the emphasis on the areas Ms. Jacklin mentioned.

In closing, we welcome the authorities' decision to publish the staff report and we wish the authorities success in their challenging policy endeavors.

Ms. Patel made the following statement:

Like other Directors, we very much welcome the resumption of the Article IV consultations with Afghanistan reflecting the country's return to normalcy, following a prolonged period of conflict and unstable security conditions that had devastating effects not only on the Afghan economy but most importantly on its social fabric. The authorities have now an opportunity to establish the basic conditions for sustainable growth and development needed to fight the deep-seated poverty, although the security situation still remains fragile.

The Afghan Transitional Administration (ATA) is to be commended for the impressive progress made under very difficulty circumstances and with limited administrative capacities, in reviving the economy and rebuilding critical institutions. A real GDP growth of 30 percent aided by a robust agricultural expansion, low inflation, and fiscal and monetary discipline were all critical for the strong and swift recovery. However, the task of managing the economy remains daunting, given the high cost of rebuilding the economic and social infrastructures and the contending need to meet the special requirements for consolidating the peace process, including resettlement of refugees and displaced people and the demobilization of the former combatants of rival factions. In this regard, there is urgency of helping the country with the necessary external resources to address these problems, as the success of economic development in Afghanistan will greatly depend on the establishment of a peaceful environment.

The adjustment process in Afghanistan is more than a short-term stabilization exercise and the authorities have accordingly adopted the National Development Framework, which will be cornerstone of the Government's policies to put the economy on a sustained growth path and address the postwar issues. It is rightly focused on security and human development, rebuilding infrastructure, and promoting the role of the private sector as the engine for growth. The success of this plan requires the consistency and perseverance in the implementation of sound policies and the maintenance of the momentum of the peace process. However, it is critical that the authorities' reconstruction and development efforts be underpinned with continued donor concessional financial support, as Afghanistan's own resources are very scarce with its per capita income being among the lowest in the world. In this connection, while we appreciate the technical assistance and advice the Fund has provided to the authorities thus far, we believe that a closer involvement of this institution in the context of a PRGF arrangement, as suggested by Mr. Mirakhor in his informative buff statement, at an early stage is important to lend credence to the authorities' policy framework, and thus help to catalyze the much-needed external financial assistance.

The authorities have demonstrated their political will to overcome the many and complex problems affecting their economy. Their efforts to maintain strong fiscal discipline and strict adherence to the "no-overdraft rule" under the current very difficult circumstances, is above all noteworthy. We welcome their efforts to lifting the revenue to GDP ratio from the current understandably very low level to meet the growing expenditure demands. We encourage the authorities to implement the planned measures in the customs and tax areas, as they will help to further enhance revenue performance. Improving the government's control over the provincial finances is critical to buttress the ongoing revenue mobilization effort, and the priority accorded to strengthening fiscal management at the provincial level is, therefore, well placed. We also find the authorities' cautious approach to civil service reform to be justifiable under the current political and social environment.

The authorities' prudent monetary policy played a key role in containing inflation at low levels and contributing to the stability of the exchange rate after the introduction of the new currency. The recent adoption of the new central bank and banking legislation were significant steps to support the creation of a sound financial system that would contribute to enhance the potential of the country. Important in this regard will be to tackle the problems of the state-owned commercial and development banks. In this respect, the authorities are encouraged to proceed with their plans to restructure or close those banks where deemed necessary.

The recovery in the opium production is unfortunate and we agree with the staff that eradication programs should be carried out to prevent its pervasive influence from becoming entrenched. Given its growing impact on the economy and the fact that it has become the main source of income for a large segment of the population, for this plan to be successful, it will be necessary to develop extensive programs that would provide alternative sources of income while at the same time, making provisions to extend social support. In this regard, we would appreciate to know if there is any work in progress and if the authorities are being assisted in preparing such programs.

With these remarks, we wish the Afghani authorities every success in handling the many challenges that still lie ahead.

Mr. Veziroglu made the following statement:

We thank the staff for their informative report and Mr. Mirakhor for his candid and helpful Buff statement. We are very pleased, as all the other members of the Board, to discuss the first Article IV for Islamic State of Afghanistan in 12 years. Given the prevailing adverse conditions in Afghanistan in terms of security problems and lack of infrastructure and institutional capacity, the progress achieved so far is commendable. However, we concur with the staff's appraisal and as many Directors emphasized, that several risks and challenges remain to sustain macroeconomic stability.

We commend the Afghan Transitional Authority for their vigorous implementation of their overdraft rule in fiscal policy by keeping the expenditures at a certain level. Although the laudable progress made in revenue collection in 2003, we believe that there is an imminent need to design a tax policy to increase tax revenues. Unregistered economy and illicit opium production are the other risk factors for macroeconomic policies. In that connection, we fully endorse any kind of technical assistance to be provided by the Fund, particularly in areas of tax policy and institutional capacity building, as is also mentioned by Mr. Reddell and Mr. Sidlauskas in their preliminary statements.

The Fund's involvement in providing technical assistance and policy advice to Afghanistan proved successful in introducing the new currency and appropriate monetary policy. The flexible exchange rate system reduces the vulnerabilities in Afghanistan which is still open to external shocks. We encourage the authorities to maintain the existing prudent monetary policy which is instrumental in keeping the inflation under control.

The staff's analysis in the report clearly indicates that Afghanistan is unable to honor its external liabilities with its limited revenue sources at this early stage of recovery. In this respect, continuation of donor support, at least in the near future, seems to be crucial for Afghanistan to achieve economic transformation and sustain sound macroeconomic policies with the sufficient financing sources as it is rightly emphasized in Mr. Mirakhor's Buff statement. In this respect, we believe that Afghanistan's Transitional Authority should also devote all its efforts to use international aids effectively in the most needed areas in order to keep the international community's interest in providing grants to the country.

Finally, we would welcome a staff-monitored program with Afghanistan, but we also share other Directors' concern on data weaknesses and the need for administrative capacity building which are essential to implement and monitor the program.

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

Mr. Kanaan made the following statement:

Several Directors have pointed to the apparent lack of a balance of payments need by Afghanistan, and suggested that such a need should be established before we start contemplating a Fund program supported by the PRGF or by Emergency Post-Conflict Assistance, which could be considered by the authorities down the road, although the authorities have thus far signaled their interest in a staff-monitored program as a first step

In my discussions with the staff about how this balance of payments need would be determined, it was made clear that it would be based on an assessment of the financing requirements on the fiscal side, notably on an appraisal of the expected financing gap of the operating budget. The staff explained that this gap, as opposed to the conventional measures based on balance of payments statistics, would be the key determinant of the balance of payments need, given the weak balance of payments statistics for Afghanistan. It is important to appreciate that the operating budget, as it currently stands, is a minimalist one in the sense that it consists largely of wages and salaries, with a minimal level of social expenditures. For the operating budget to be a meaningful one and to fully reflect the "pressing" expenditure requirements, it needs to take into account the results of the full-fledged needs assessment that is currently underway (and is led by the World Bank and the UNDP). It is important to emphasize that once the results of the needs assessment become available, the operating budget should be revised to incorporate in a more complete and meaningful way the social expenditure needs, including at the level of the provinces. This will be a major challenge, given that at present very little is known about the pressing social expenditure requirements at the provincial level.

To illustrate, Table 3 in the staff report shows a projected financing gap of $62 million in the operating budget for fiscal year 2003/2004. This relatively small sum, especially when compared to the much larger requirements of the development budget, may lead some to conclude that there is no substantial and pressing balance of payments need for that year. However, the Fund needs to exercise due diligence, once the needs assessment is completed, to present a fuller picture of that gap, taking full account of the social expenditure requirements, distinguishing between those that are urgent and those which are needed in the longer term. Such diligence is important to ensure a proper determination of the size of the balance of payments need in the short- and medium-term, in preparation for the possibility of either post-conflict assistance or for a PRGF arrangement, which could be requested by the authorities as soon as the middle of next year.

The staff representative from the Middle East and Central Asia Department (Mr. Bennett), in response to questions and comments from Directors, made the following additional statement:

> A number of questions were raised during the course of the discussion. In response to the comments made by Mr. Misra about the staff taking note of bilateral contributions, let me assure Directors that bilateral contributions are taken into account. For example, in Table 2 of the staff report lists bilateral contributions, including India's contribution, in the operating budget.
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> There was a question about the entry of foreign commercial banks. In addition to the bank I mentioned earlier, the Aga Khan Bank linked with the IFC and Asian Development Bank which has applied for a license, there is also the National Bank of Pakistan, and Standard Chartered Bank.
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> On the issue of dollarization, we are not sure of the extent of dollarization in Afghanistan since it is hard to measure. Afghanistan is an entirely a cash economy and is likely highly dollarized. We suspect the opium business is contributing to this process, which clearly complicates monetary management. Concerning what could be done about this, ensuring financial stability to maintain confidence in the national currency is the most important task to achieve. That is actually the conclusion of the recent Board paper on this subject.
>
> There was also a question about seeking more information on provincial budgets. In principle, Afghanistan has a centralized fiscal system, with revenues from the provinces going to the center and all the spending, even those undertaken in the provinces, being paid out of the center. In practice, the reality is rather different in certain cases. We visited Herat in northwest Afghanistan on our last mission in September, which we judged to be a reasonably safe location to undertake some investigations. We met with officials of the local ministry of finance, the local office of the central bank, and with the governor himself. As you know, most cities are less secure, so this is not something that can always be done conveniently at this point in time.

The staff representative from the Policy Development and Review Department (Mr. Fisher), in response to questions and comments from Directors, made the following additional statement:

> Mr. Kanaan raised a number of questions about balance of payments needs and the use of Fund resources. The concept of the need for the use of Fund resources is that it must be temporary in nature. It is an opportunity to give members comfort to correct maladjustments in their balance of payments. Therefore, it is very important that the need we are financing should both be

temporary in character, because it will respond to policies, and that the member should have the capacity over time to make repayments to the Fund.

I have no doubt that Afghanistan has extraordinarily large developmental needs for infrastructure development and pressing social problems. But, Fund credit cannot be used as a substitute for long-term development assistance.

The Board has established a policy of post-conflict assistance, which requires that a member should have the capacity to implement a program, should have a pressing balance of payments need, and should have the capacity to repay the Fund. The staff will be keeping these issues under review in our continued dialogue with the authorities.

Mr. Kanaan agreed with the staff's comments, which was why it was important to separate the pressing expenditure needs that the staff rightly classified under the operating budget, from the development budget, which focused on the longer-term needs. Directors should ask themselves whether there were pressing expenditure needs that had to be satisfied urgently. The staff had done a good job in asking where the pressing needs were. However, the needs assessment currently being undertaken would be able to further clarify whether there were exceptional needs that had to be satisfied immediately. If that was the case, those exceptional needs should be treated separately and should be taken into account when determining the need for Fund financing.

Mr. Faircloth clarified that his comment on the need for a greater regional dimension of the Afghan economy was not a critique of the staff, but was to emphasize that the security situation was difficult and that broadening IMF's involvement with Afghanistan would require due consideration for the security situation.

Mr. Mirakhor made the following concluding statement:

The staff has answered all the questions that were posed to them, and I do not have much to add except to thank the Board for its interest and support. I also would like to mention that the staff representative from the Middle East and Central Asia Department and his team have worked very hard and have prepared good reports. Unfortunately, we will not have the opportunity to continue working with the staff representative on Afghanistan much longer, and wish to emphasize that he has been extremely helpful and that my authorities are grateful for his assistance.

I also would like to thank the IMF Senior Resident Representative in Kabul and staff in the Monetary and Financial Systems Department for their extremely helpful technical assistance. I will not enumerate the World Bank's assistance, given the lateness of the hour, but it has been extraordinarily helpful. I also extend my thanks to management.

The Acting Chair (Mr. Carstens) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the opportunity to assess Afghanistan's economic performance and prospects for the first time in 12 years. They were strongly encouraged by Afghanistan's important progress over the past 18 months in rebuilding key institutions and restoring macroeconomic stability. Directors were particularly encouraged by the authorities' strong commitment to prudent macroeconomic policies and management, which, together with sizable international aid and the end of the drought, had provided an environment conducive to the resumption of economic growth. They expressed strong concern that any worsening in the fragile security situation might jeopardize the progress achieved so far and emphasized the need for the international community to continue to play a key role in the reconstruction process.

Directors noted that the government would require substantial resources in the period ahead in order to address more aggressively the many basic needs in the areas of security, health, education, and institutional reforms. They viewed progress in these areas as a necessary condition for promoting sustainable economic growth. In this regard, Directors underscored the importance of maintaining substantial donor assistance.

Directors supported efforts to put in place revenue-raising measures to reduce the dependence of the operating budget on donor assistance in due course. They supported measures to broaden the sources of revenue through tax policy and customs reform and improved collection, particularly from the provinces. Although significant strides have already been made in improving fiscal management, Directors looked forward to further progress in improving revenue transfers from the provinces to the central government, and budget formulation and execution.

Directors encouraged a process of meaningful civil service reform, including to the civil service wage system. They welcomed the progress toward the integration of donor projects into the development budget, which would facilitate the comprehensive monitoring of projects, and ensure their consistency with the authorities' overall strategy, as outlined in the National Development Framework, and thus promote a greater contribution of the authorities to the "ownership" of these projects. They emphasized the importance of this process, especially as donor assistance gradually shifts from budgetary support to development and reconstruction.

Directors commended the authorities on the successful introduction of the new currency and noted that introducing a new currency in a post-conflict environment such as in Afghanistan was a major accomplishment. They regarded prudent monetary policy supported by strong fiscal discipline, including the "no-overdraft" rule for budget financing that prohibits central bank financing of the deficit, as instrumental in ensuring the stability of the exchange rate of the new currency. On the exchange rate regime, Directors saw merit in a "lightly managed" float for a country which remains vulnerable to shocks, and is undergoing structural changes and reconstruction, though a few Directors cautioned against using a narrow or rigid target range for the exchange rate.

Directors welcomed the authorities' commitment to a liberal trade and exchange regime and urged them to act swiftly to clarify the regulatory environment. They supported the provision of Fund technical support to draft the appropriate laws and regulations needed for the acceptance by Afghanistan of the obligations under Article VIII, Sections 2, 3, and 4.

Directors commended the creation of a supervision department in the central bank, and emphasized the importance of further developing regulatory and supervisory capacities, and restructuring and privatizing state banks. They urged tighter control of informal mechanisms of financing, and the introduction of anti-money laundering and controlling the financing of terrorism legislation.

Directors considered that the authorities faced major challenges and risks in their efforts. They concurred that one of the most prominent risks is a lack of security and the limited rule of law, highlighted by the government's limited control over the provinces. They considered that restoring adequate security throughout the country remains a key priority to facilitate the implementation of reforms and projects, as well as the resumption of private economic activity and the provision of basic public services beyond Kabul. In this regard, Directors stressed the need for the international community to support the government in its efforts.

Directors were concerned about the serious risks posed by the rise in poppy cultivation and the production of opium in Afghanistan to levels of the late 1990s. In this regard, they urged the authorities to intensify eradication programs with the help of the international community, and to provide farmers with alternative livelihoods to avoid a downward spiral of violence and corruption.

Directors considered that poverty alleviation in Afghanistan will require strong economic growth for many years to come, as per capita GDP remains one of the lowest in the world. They observed that a key support in sustaining economic growth, and reconstruction and development, will be maintaining a high level of donor support, predominantly in the form of grants, in view of Afghanistan's limited debt servicing capacity. Directors welcomed the debt relief that had already been provided by some countries and encouraged the authorities to pursue debt cancellations from other major creditors and regularization of relations with all creditors. They welcomed the formation of a debt management unit.

Looking ahead, they emphasized the importance of Afghanistan attracting substantial private investment to eventually take the place of official assistance and in general of developing a solid private sector. They also encouraged the authorities to prepare the ground for privatization of state-owned companies. Directors saw several key areas of reform as preconditions, including putting in place a functioning financial system, a market-oriented regulatory framework, and a functioning and fair legal system to firmly establish the rule of law and the security of property rights.

Directors stressed that the process of maintaining macroeconomic stability and moving the reform program ahead will require sustained efforts to strengthen and maintain the political and public consensus for the reforms, strong policy actions, the support of the international community, and a strengthened administrative capacity. To this end, Directors supported Afghanistan's intention to undertake a staff-monitored program in the period ahead. They viewed this as an appropriate framework for improving policy formulation capacity, strengthening economic management, and better coordinating and targeting technical assistance, and an important step for the preparation for a PRGF arrangement. They encouraged the authorities to make full use of donors and Fund technical assistance. In this context, some Directors referred to the possibility of a post-conflict arrangement.

In view of the poor quality of Afghanistan's macroeconomic statistics, Directors welcomed recent improvements in the quality of fiscal and monetary data and indicated that substantial efforts will be needed to bring the data quality to levels adequate for surveillance and program monitoring.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/03/107 (11/19/03) and EBM/03/108 (11/21/03).

7. NEPAL—POVERTY REDUCTION AND GROWTH FACILITY—THREE-YEAR ARRANGEMENT

Pursuant to paragraph 3 of the decision of November 14, 2003, the Fund decides that the World Bank has concluded that the PRSP submitted by Nepal provides a sound basis for World Bank concessional financial assistance. Accordingly, the approval of the three-year PRGF arrangement for Nepal set forth in EBS/03/147, 11/3/03 and Corrections 1 and 2, 11/13/03 shall become effective on the date of this decision. Furthermore, the date

"November 14, 2003" in paragraph 1(a) of the arrangement shall be revised to the date of this decision. (EBS/03/147, Sup. 1, 11/19/03)

Decision No. 13134-(03/108), adopted
November 19, 2003

8. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 03/79 are approved.

9. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director, by Senior Advisors to Executive Directors, and by Advisors to Executive Directors as set forth in EBAM/03/157, (11/19/03) is approved.

APPROVAL: February 27, 2004

SHAILENDRA J. ANJARIA
Secretary