

Syrian Arab Republic

IMF Article IV Consultation

Mission Preliminary Conclusions

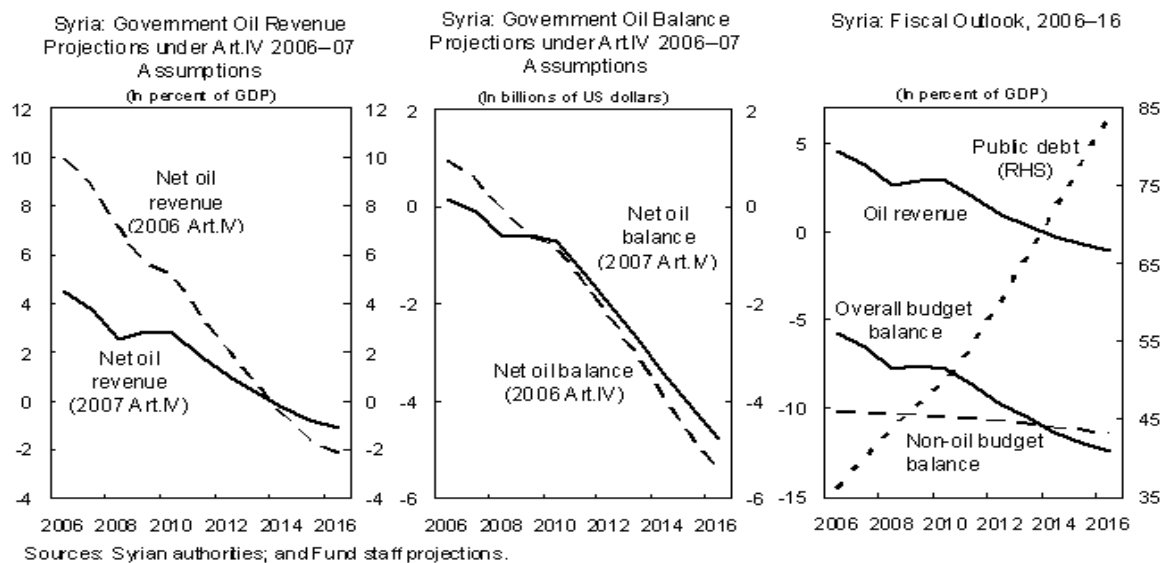
May 16, 2007

1. **The Syrian economy did remarkably well in 2006.** Despite an unsettled regional environment, the economic recovery that started in 2004 remained on track. Non-oil GDP grew at a brisk pace (tentatively estimated at 6-7 percent), job creation picked up steam driving unemployment below 10 percent, private investment gathered momentum, and exports made strong gains, particularly in some Arab markets. The surge in the volume of investment approvals hints at brightening investment prospects with companies jockeying to position themselves in the fledgling market. Not only was Syria able to raise the living standards of its own citizens, it also offered shelter, food, medicine, schools, and hospitals to the 1½ million Iraqis that sought refuge in Syria. Despite the large demand shock this represented, inflationary pressures have been fairly contained thanks to tighter credit policy and fiscal discipline.

2. **This economic revival owes much to the reform impetus initiated 2-3 years ago and sealed by the adoption of the ambitious 10th 5-year development plan.** Broad-based reforms have made significant changes in the economic and financial landscape. The exchange rate has been effectively unified and virtually all restrictions on access to foreign exchange to finance imports have been eliminated. Most economic sectors have been opened to private enterprise, boosting the contribution of the private sector to non-oil GDP above 80 percent. A dynamic private banking sector is now leading financial sector growth, and the Damascus stock exchange is set to open early next year after being closed for 40 years. A new investment law has liberalized the investment regime further, created a one-stop-shop for investors, and put foreign and domestic investors at par. Complex, opaque and prohibitive taxation has been replaced by more efficient and equitable taxes and tax administration has been modernized to support the new tax legislation. In addition, law number 51 enacted in October, 2006 unified tax incentives for investment. The local industry has been exposed to greater international competition through several rounds of tariff cuts—which brought the average tariff rate to 14½ percent down from close to 20 percent three years ago and the maximum rate from 225 percent to 60 percent; a reduction in the number of prohibited imports; a relaxation of import licensing procedures; and a simplification of customs clearance. Strides are being made in building the regulatory frameworks to govern the new market economy, most notably in the banking, insurance, and capital markets, and in housing and real estate. Last but not least, improvement in the efficiency of the taxing system and

strict fiscal discipline ensured a timely adjustment to a large and precipitous loss of oil revenues.

3. **Notwithstanding the progress in the reform agenda the remaining challenges are still daunting.** According to the latest projections of oil production, government revenues from oil, which have fallen more rapidly than initially anticipated, are projected to decline by a further 5 percentage points of GDP in the next 10 years, while the net oil import bill could reach US\$6 billion (about 7-8 percent of GDP) ten years from now. Macroeconomic instability will heighten and the growth momentum will falter if the government will to undertake the difficult fiscal reforms ahead wanes and if the structural reform drive is not sustained and accelerated. Under this scenario, time could be bought by drawing down the large stock of international reserves. This would support the nominal exchange rate for a few years, but monetary financing of the widening budget deficit will fuel inflation and crowd out the private sector through an appreciation of the real exchange rate, dampening the economy's growth potential. Once international reserves are exhausted, a forced adjustment through an inflation-cum-depreciation spiral would become unavoidable. An additional cumulative fiscal adjustment of some 10 percent of GDP in the next 10 years is needed to avert this scenario.



4. **Analysis of recent economic developments is increasingly constrained by data weaknesses.** These have been amplified in the recent past as the acceleration of structural reforms has severely tested the ability of a weak statistical infrastructure to cope with the changes. The situation in Iraq added to the challenge. The main drivers of the ongoing economic revival, namely exports, private investment, and private sector activities in general are not adequately surveyed. Pervasive subsidies and weak accounting standards in public enterprises (PEs) are a major challenge to the weak methodological framework underlying the compilation of the national accounts and introduce a significant margin of error in growth

estimates. The move to a new CPI, although based on a more representative consumer basket, has unfortunately introduced uncertainty about the level of inflation and its trend. Revisions to weak customs data—to account among other things for the intensification of shuttle trade with Iraq—have blurred the picture as to the underlying strength of the non-oil current account balance.

5. **Economic analysis and macroeconomic management are complicated in this statistical vacuum, and the authorities are encouraged to be vigilant in monitoring the state of the economy**, particularly inflation and foreign trade. Utmost priority should be given to mobilizing the needed expertise to upgrade statistics. Pending tangible improvements in the quality of the data, research units at the Deputy Prime Minister's Office, the Ministry of Finance (MoF), the Central Bank, and the State Planning Commission should not be constrained by the use of "official data" and should be encouraged to work closely together to fill in the data gaps with economic analysis and consistency checks among the key sectors (fiscal, monetary, external, and real sectors) to come to a reasonable understanding of current developments. Given the data weaknesses, the mission's assessment is only tentative.

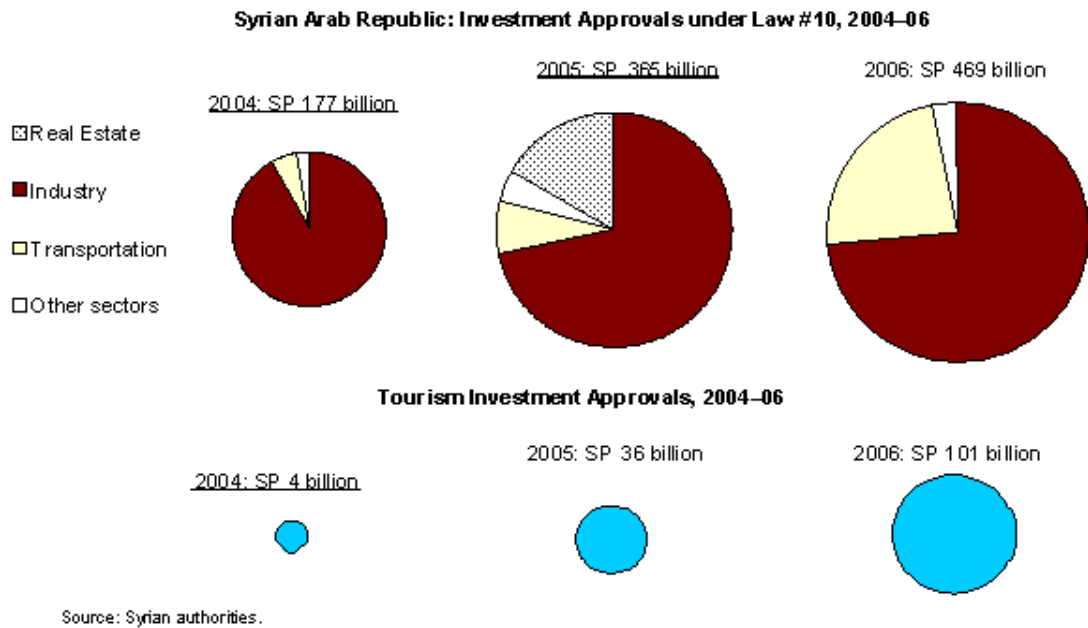
I. Recent Developments and Near-term Outlook

6. **Staff estimates growth of non-oil GDP at around 6-7 percent in 2006.** Given a 6½ percent drop in oil production, this would be consistent with an overall growth of 4½ -5 percent. Growth appears to have been mainly driven by private consumption and non-oil exports and may have been supported by some strengthening of private investment. Private consumption was boosted by employment and wage gains, a good harvest (particularly for olives whose production doubled); and the boom in real estate and rental prices, which translated into a significant wealth effect for property owners; amidst the influx of Iraqis. The strong performance of non-oil exports, which are estimated to have increased by about 30 percent in 2006, reflects the surge in exports to Arab countries, which were boosted by stronger demand as well as the granting of free access under the Great Arab Free Trade Area.

7. **The improved business climate might be supporting a steady growth in private investment, but a real take-off does not seem to have materialized yet.** Nonetheless, the impressive volume of approved projects under Law No 10 in 2006—which reached SP 470 billion (US\$9.2 billion and 26 percent of GDP) more than 2½ times the level in 2004—and their diversity augurs well for growth prospects in the near- to medium-term.¹ Almost three-fourths of the volume of these investments are in increasingly diversified industrial projects (including cement, steel, food processing, pharmaceutical, textile, and power generation), and

¹ Quoted figures for investment approvals include the cost of fixed capital and the working capital for one production cycle. A more useful aggregate to monitor would be the cost of fixed capital, only, as it provides a better proxy for investment proper, as opposed to intermediate consumption.

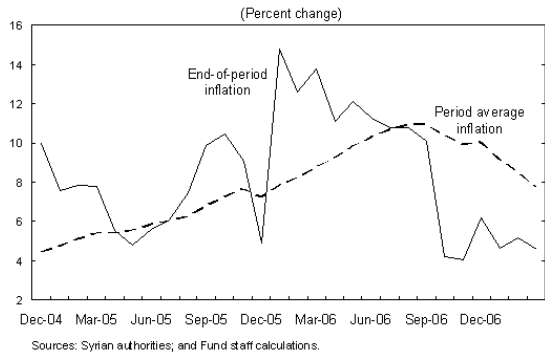
another 20 percent are in the transport sector. Investment in the much publicized real estate projects (consisting of commercial, recreational, and other services associated with government housing projects) represented only about 15 percent of the total approved projects in 2005 (SP 60 billion) and their social returns—which are feared to be low in some circles—may actually be quite high if they are part of a well diversified investment strategy. The share of foreign direct investment (FDI) is estimated to have remained fairly stable at about 20 percent.² Diversity in the investment strategy is also evidenced by the equally strong growth in investment approvals in tourism. Prospects in that sector are strengthening, with the ministry of tourism now preparing to launch mega projects, based on the success it achieved in attracting investors' interest in smaller projects.



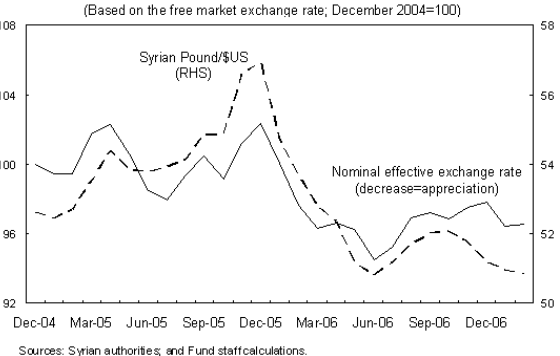
8. **The build-up of inflationary pressures since mid-2005 seems to have abated in recent months.** While average inflation increased from 7.2 percent to 10 percent in 2006, trend inflation as measured by the increase in the price level in March 2007 compared to March 2006 has come down to 4 percent, bringing average inflation to below 8 percent. Half of the increase in inflation in 2006 is attributed to an increase in food prices, which may have reflected weather-related shortages plus stronger domestic demand as well as demand from neighboring countries hit by similar inclement weather. The increase in the dollar price of imported non-fuel commodities together with some pass-through of the exchange rate depreciation at end-2005 may have been additional contributing factors.

² Data existed on the volume of investment in joint venture projects, where the share of the foreign partner is greater than 10 percent. It is believed that the actual share of foreign partners is about 70 to 80 percent.

Syrian Arab Republic: End-Period and Period Average CPI Inflation, 2004-07



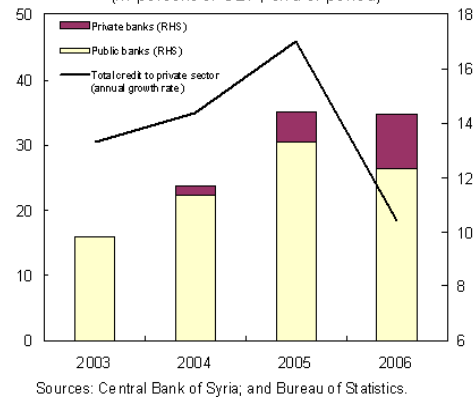
Syrian Arab Republic: Exchange Rates, 2004-07



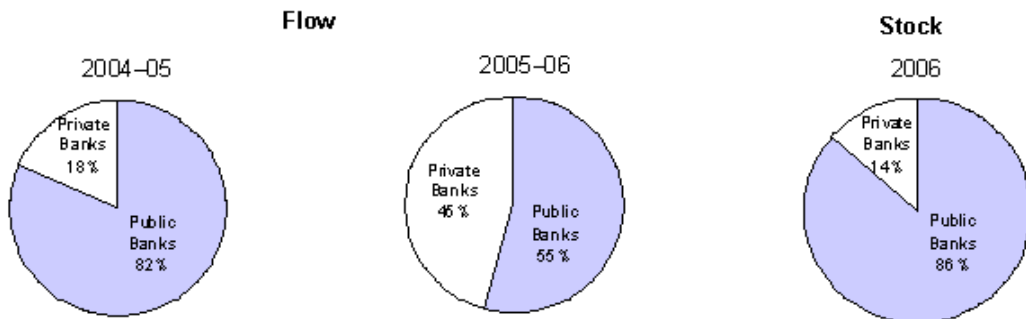
9. **The large influx of Iraqis put strong pressures on the economy.** The number of refugees grew by 40 percent in 2006 to about 1.5 million (8 percent of the Syrian population). In addition to contributing to inflationary pressures, including notably in rental and real estate prices, the surge in refugees strained government expenditures, particularly on energy and food subsidies, and spending on health and education.

10. **Credit policy played a useful role in controlling domestic demand.** State banks were instructed to slow their lending to the private sector, which helped cool the credit boom experienced in 2004-05. The actual pace (18½ percent), while still fast, reflects the process of financial re-intermediation related to the nascent private banking sector, whose loan portfolio increased by more than 100 percent, accounting for almost half of the credit growth in 2006. The increase in net lending to the public sector contributed the largest share in the increase in money. Administered deposit interest rates, which turned negative during most of 006, are now back to positive territory, thanks to the deceleration of inflation.

Syria: Credit to the Private Sector, 2003-06 (In percent of GDP; end of period)



Syrian Arab Republic: Stock and Flow of Credit to the Private Sector, 2004-06



Syrian Arab Republic: Sources of Money Creation

	2003	2004	2005	2006
	(Change in percent of initial stock of money)			
Net foreign assets	4.2	7.1	2.3	-1.7
Domestic assets (net)	3.5	6.4	9.7	16.3
Domestic credit	4.7	8.8	16.1	13.1
Net claims on the public sector	0.6	3.1	7.2	8.4
Net claims on central government	0.7	3.7	7.9	0.7
Net claims on public enterprises	-0.1	-0.6	-0.7	7.7
Claims on private sector	4.1	5.7	8.9	4.6
Other items (net) 1/	-1.2	-2.5	-6.4	3.3
Money (M2) 2/	7.6	13.5	12.0	14.6
Memorandum items:				
Credit to the private sector (percent change)	30.3	35.0	45.9	18.4
Public banks	30.3	31.0	38.7	10.9
Private banks	281.7	106.9

Sources: Syrian authorities; and Fund staff estimates.

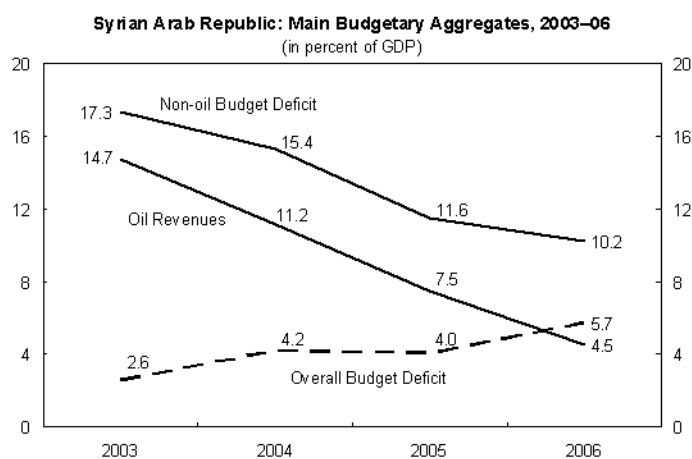
1/ In 2006, the increase in other items net reflects, in large part, the use of part of the valuation adjustment account of the CBoS to finance the budget deficit.

2/ Net of public enterprise deposits.

11. Timely and significant fiscal adjustment largely offset the decline in oil revenues, thereby containing the fiscal deficit. Over the last three years, fiscal policy had to contend with a loss of oil revenues in excess of 10 percentage points of GDP.

This has reflected both a sharp contraction of oil production from about 480 thousand barrels per day to about 400 thousand and a galloping growth in domestic demand (an annual average rate of 10½ percent) owing to a decline in the prices of refined products in real terms, increased smuggling to neighboring countries, and the impact of the Iraqi refugees. A

cumulative improvement in the non-oil budget deficit of 7 percentage points of GDP narrowed the non-oil budget deficit to about 10 percent of GDP, strengthening significantly the medium-term prospects of fiscal sustainability.



12. The quality of the fiscal adjustment was commendable. During the last three years, corporate income tax rates have been lowered drastically—with the top marginal rate coming down from 65 percent in 2003 to 28 percent in the latest amendment—and tariffs rates have

been reduced significantly. Tax administration improvements together with higher growth fully compensated for the cut in rates and helped maintain a stable tax intake as a percent of GDP and increase its total volume. The bulk of the fiscal adjustment has been contributed by caps on investment spending and an increase in dividend payments from profitable public companies, mainly in telecommunication, which boosted nonoil revenues by close to 3 percentage points of GDP during 2004-06. The compression in capital spending is largely believed to have represented cuts in wasteful spending, and at 9 percent of GDP, its level in 2006 is still fairly high. The creeping rise in current expenditures reflected mainly the increase in subsidies to loss making PEs and pension and social assistance payments.

Summary of Fiscal Operations, 2003-06
(in percent of GDP)

	2003	2004	2005	2006 Prel. Est.	Cumulative change during 2004-06
Revenue	28.8	27.2	24.4	21.9	-6.9
Oil revenues	14.7	11.2	7.5	4.5	-10.2
Non-oil revenue	14.0	16.0	16.9	17.4	3.3
Non-oil tax revenue	10.5	11.5	10.7	11.2	0.7
Non-oil non-tax revenue	3.4	4.4	6.0	6.2	2.7
<i>Of which:</i> Surplus of PEs	3.0	3.8	5.1	5.5	2.5
Expenditure	31.4	31.4	28.4	27.6	-3.7
Current expenditure	17.7	19.0	18.1	18.7	1.0
Development expenditure	13.7	12.4	10.3	8.9	-4.8
Overall balance	-2.6	-4.2	-4.0	-5.7	-3.1
Non-oil balance	-17.3	-15.4	-11.6	-10.2	7.1

Sources: Syrian authorities; and Fund staff calculations.

13. **The growth outlook for 2007 remains favorable.** The critical mass of reforms implemented in recent months, the continued direct and indirect support of aggregate demand from the Iraqi presence, and favorable growth prospects globally and in the region are expected to continue to underpin private consumption and non-oil exports, as well as a possible strengthening of private investment. These factors could sustain the growth momentum at about the same pace as in 2006.³ Any slowdown of capital inflows associated with the Iraqis will dampen aggregate demand directly and through second round effects, including an unwinding of the wealth effect induced by the real-estate boom. However, a normalization of the political situation in Iraq could open a large market for Syrian products.

³ Given the projected 7 percent decline in oil GDP, this would be consistent with overall growth of 4½ percent.

14. **To keep inflationary pressures in check, macroeconomic policies should remain appropriately tight.** The current level of benchmark interest rates is appropriate and state banks' lending should remain in line with the monetary objectives. Fiscal policy should aim to reduce the overall budget deficit to about 5 percent of GDP mainly by phasing out petroleum price subsidies and further rationalizing of expenditures. Civil service wage policy, which leads wage policy in the rest of the economy, has a major role to play in curbing inflation, by ensuring that wage increases do not run ahead of productivity gains.

II. Building for the Future

15. **Syria needs to continue to grow faster but it also needs to grow *better* in the coming years.** The growth acceleration in the past two years seems to have been largely driven by private consumption, with an initial impulse originating from the influx of Iraqis. For this growth to strengthen and solidify, it is important that the sources of growth be rebalanced toward investment and durable gains in external market shares. Stronger investment growth and higher productivity are the bedrocks of high and sustainable growth in the long run.

16. **To rebalance growth, Syria should continue to strengthen its macroeconomic policy frameworks and to accelerate structural reforms.** Policies geared toward accelerating reforms and preserving financial stability could validate investors' expectations and strengthen savers' confidence about returns on Syrian assets. A positive synergy—such as the one witnessed in the rapid take-off of private banking—between an increased willingness on the part of savers to invest their funds in Syria rather than abroad or in idle foreign currency, and an increased willingness of investors to take the risk of starting new projects could *turn the promise from the large increase in investment approvals into a reality.*

17. The remainder of this statement focuses on: (i) policies to protect fiscal solvency, (ii) a more explicit monetary policy framework in the context of the unified exchange rate regime to anchor price stability, and (iii) key structural reforms.

Fiscal sustainability

18. **The timely adjustment to the secular trend decline in oil revenues in the past three years is highly welcome.** Looking forward, there is a need to sustain this effort as oil revenues continue to dwindle. Addressing all the pockets of inefficiency in public spending associated with technical losses and across-the-board subsidies to consumers, producers, and public employment will achieve durable fiscal savings while enhancing the supply side of the economy. A large share of the freed up resources could be channeled to finance targeted support to the most vulnerable segments of society and to productive expenditures on basic infrastructure, higher education, and research and development. This will complement private investment by enhancing its potential returns.

19. **In this regard, a comprehensive public expenditure review is essential.** It should focus on: (i) settling the inter-enterprises arrears among PEs and stopping any such accumulation in the future as this practice dampens incentives for sound and transparent financial management and leads to a lack of accountability; (ii) reviewing the efficiency and effectiveness of expenditures in major sectors such as education, health, and public transportation with a view to reprioritization and deep reforms; and (iii) reviewing the social protection system—the current system is mostly based on rationing (coupons) and on inequitable and inefficient price subsidies. It needs to be reformed toward means-tested targeted transfers.

20. **Phasing out the inequitable petroleum price subsidies (PPS), whose cost exceeds 15 percent of GDP, is a key pillar of fiscal reform.** Beyond large fiscal savings, it would provide significant efficiency gains, improve equity, entail a smaller negative fiscal impulse, and contribute to BOP adjustment. We are encouraged to know that some preparatory work is being done to launch this reform, and urge the authorities not to delay it further. Each day the public coffers lose SP 750 million (i.e. close to US\$15 million, three times the annual budget devoted to promoting tourism) on a policy that has lost all purpose, while so many legitimate claims on public money remain unfulfilled.

21. **Stepping up preparations to introduce a VAT is needed to ensure that the VAT is phased in on time to help offset the future drain on oil revenues.** The mission agrees that an ill-prepared launch could damage the credibility of this new tax, and indeed many steps, including the adoption of a tax procedures code and an integrated IT system, have yet to be completed. However, preparation could move much faster, if the authorities were to choose a simple design, an option that would very much be in line with the new vision driving tax policy reform toward simpler taxes and lower rates. A uniform rate with very few exemptions lowers the compliance costs on taxpayers and the burden on the tax administration and closes loopholes, which create opportunities for corruption. Concerns about social equity are best addressed by excises on luxury goods, well targeted spending programs, or by enhancing the progressivity of income taxes.

22. **The authorities view the PE reform as an important element in the reform program. For that the authorities issued:**

- Law # 2 in early 2005 for PEs which further their financial independence including their ability to borrow from the banking sector, to engage in joint venture with the private sector and to contract private management teams.
- Law # 54 of October 1st, 2006 (Basic Finance Law) which gave PEs real financial autonomy including full responsibility for financing their activities and the right to keep their operational surpluses. The law would be implemented starting with the 2008 budget and the MoF is currently working on issuing a law that would resolve the financial obligations of PEs vis-à-vis the Public Debt Fund.

While appreciating these important steps, the mission encourages the authorities to restructure enterprises that can be restructured and develop case-by-case solutions, including liquidation, to deal with the rest. In addition, the mission encourages the authorities to consider privatizing selected enterprises.

Strengthening The Monetary/Exchange Rate Framework

23. **The Central Bank of Syria (CBS) has done a commendable job over the past two years in managing the exchange rate arrangement.** Progressive liberalization of access to foreign exchange for current account transactions and skillful exchange rate management dismantled barriers within the previously segmented foreign exchange market and gradually guided the parallel market rate closer to the official rates. This process culminated in an effective unification of the exchange rate and progress toward current account convertibility at the beginning of this year. Progress toward unification and current account convertibility remained on track despite politically driven jitters in the foreign exchange market, which resulted in a weakening of the currency in late 2005. Since the unification early this year of key rates used for trade, the central bank has continued to manage the exchange rate with a view to ensuring orderly conditions in the foreign exchange market and a fairly stable exchange rate.

24. **Credibility of the new foreign exchange system will be enhanced, if all the remaining restrictions on current account transactions are lifted and if the recent liberalization is given a legal shape in the form of a new foreign exchange law.** Lifting the remaining restrictions on current account transactions (such as the restrictions on access to foreign exchange to finance car imports, payments and transfers on the invisibles account, and remaining multiple currency practices) would have a very limited impact on the balance of payments, if any. Their removal would enable Syria to accept the obligations under Article VIII of the IMF Articles of Agreement and hence join the 166 members of the IMF (out of 186), which have already done so. The enactment of a new foreign exchange law, which would abrogate the complex and arcane set of foreign exchange laws and regulations and enshrine the principles of full current account convertibility, a unified exchange rate, and the standard provisions for the repatriation of profits from FDI, would send a strong signal about the irreversibility of reforms and the authorities' commitment to re-entry into the global economy. This is essential for the stability of the foreign exchange market and for attracting larger volumes of FDI.

25. **Adopting a central bank law that enshrines price stability as the main objective of monetary policy will be key to strengthen the credibility of the monetary policy framework.** This requires building consensus about a clear mandate for the central bank *as a core institution of a market economy*. Because the best way in which monetary policy can contribute to long run growth is by instilling confidence in the future through maintaining price stability and avoiding price level shocks that upset business planning and redistribute income and wealth in an arbitrary way, an overwhelming number of countries have embraced

the idea that the primary objective of the central bank should be to maintain price stability. Full government support to assigning this clear mandate to the central bank is important to gain credibility of monetary policy with the markets and has to be backed by a disciplined fiscal policy to help achieve the inflation objective. If assigning this clear mandate to the central bank has the full support of the authorities, *the central bank should be granted autonomy in discharging its mandate, subject to full transparency and accountability provisions. Autonomy hinges critically on giving full responsibility and authority to the central bank to decide on an appropriate stance for monetary policy and exchange rate management.* It is also critical to grant the central bank the operational autonomy to set its own budget within agreed guidelines with the government. This will allow the central bank to hire and retain highly qualified staff by improving the wage structure to better match that of the private sector and devoting more resources to training. Both of these improvements are necessary if the central bank is to manage successfully the more complex monetary and financial system that is now beginning to emerge.

26. **Continuing to use the exchange rate as the main nominal anchor of the monetary policy framework will serve Syria well in the near-term.** Given the rudimentary monetary instruments, the exchange rate is the only nominal variable the central bank can target effectively for the moment. This policy has proved effective in the past in achieving price stability, as the exchange rate had a strong correlation with inflation, and much stronger than any other possible nominal variable. However, greater exchange flexibility will be needed in the future to facilitate adjustment, which may well be required, given the prospective depletion of oil reserves and further trade liberalization. The gradual move toward greater exchange rate flexibility will also be beneficial to avoid getting trapped in "fear-of-floating" effects. Exchange rate flexibility will enhance the incentives for financial intermediaries and their clients to internalize the risks from dollarization. Lack of flexibility could lead to moral hazard and incite banks and the corporate sector to take excessive exchange rate risk, leading to a fast spread of dollarization. The degree of dollarization of bank deposits has already tripled in the last three years and is at 20 percent system-wide and at over 50 percent for private banks.

27. **A move towards greater exchange rate flexibility would require a number of steps.** The foreign exchange market needs to be developed, including market infrastructure to support the pricing and management of foreign exchange rate risks. The central bank needs to develop market-based instruments of monetary control to manage liquidity; ensure an efficient allocation of liquidity through price clearing mechanisms rather than administrative quantitative allocations; and to allow the authorities to signal policy intent through changes in the key policy interest rates. In the near term, the CBS could consider liberalizing deposit rates for all maturities except on short-term deposits, which would still allow the central bank to determine the benchmark interest rate. This will give flexibility to banks to adjust the structure of their interest rates in line with market conditions. The central bank could also introduce deposit facilities, including possibly a short-term facility for overnight deposits that

would seek to guide the interbank money market rate (using a pre-announced rate) and a longer term facility which would be designed to mop up excess liquidity.

28. **The mission urges the authorities to move swiftly on the much delayed agenda of launching a government securities market.** By accepting to pay a market-determined price for liquidity as does the private sector, the government will send a strong signal about its commitment to fiscal discipline and to an optimal allocation of liquidity. Some of the additional interest payments on the new marketable securities will be offset by increased dividend payments from the CBS and state banks and higher taxes from private banks. Moreover, the development of a T-bill market will provide an efficient benchmark yield curve and a risk-free rate of return—both necessary for the proper pricing of financial assets, in addition to facilitating the conduct of monetary policy and the development of money and interbank markets. Dealing with the foreign assets held at the Commercial Bank of Syria (CboS) and the nonmarketable old "treasuries" currently held by the CBS and other state banks offer an excellent opportunity to introduce negotiable and tradable government securities—a step that could be followed shortly after by regular auctions of new securities. The authorities expect to start the T-bill market in 2008.

Financial Sector Development

29. **Notwithstanding the commendable efforts made to develop the financial sector⁴, there are still numerous impediments and several sources of vulnerabilities:**

- Future development of a competitive banking sector will be constrained by the lack of rapid progress in state banks' restructuring. This will continue to fuel resistance to greater competition as under increased competition, the inefficiencies of state banks will lead to a loss of market share and hurt their profitability.
- Slow progress in developing market-based instruments of monetary control is increasingly at odds with the rapid advance of private banks. Moral suasion and controlling deposits rates are not the tools to manage liquidity in an increasingly market-driven banking sector; the former is totally ineffective, and the latter constrains competition. Moreover the absence of market-based instruments imposes heavy costs on banks in managing Syrian pound (SP) liquidity, discouraging the mobilization of deposits and lending in SP, leading to the perverse effect of encouraging dollarization.

⁴ Six private banks started operations and others, including Islamic banks, are expected to start their operations in 2007. In addition, the insurance sector witnessed important developments in 2005-06 including the establishment of supervisory authority, opening the sector for private investment, licensing eight private insurance companies. More companies are expected to be licenced in 2007 including Takaful/Islamic insurance.

- Sizeable risks would mount if progress in building up regulatory and supervisory capacity does not keep pace with financial liberalization. Systemic risks could go undetected, and excessive risk taking in some banks could threaten their solvency.
- Lastly, slow progress in developing the payment system imposes large costs on banks.

30. **As a priority, the central bank needs to build capacity to conduct effective banking supervision.** Although the building blocks for better supervision are being put in place, regulatory forbearance remains, undermining the impact of the supervisory process, for example, in the evaluation of minimum capital adequacy, credit quality and other activities; particularly relevant for the weak public sector banks. Equally worrisome is the limited ability of bank supervision to assess the adequacy of banks' internal controls and their risk management practices. The CBS's supervisory role is also undermined by the existence of other regulatory agencies and weak operational independence.

Trade Liberalization And the Business Climate

31. **Building on the progress achieved so far, further efforts in trade liberalization should focus on removing the remaining nontariff barriers.** Remaining trade-related barriers, in particular licensing requirements for imports and non transparent fees, need to be phased out as they increase transaction costs. To fulfill the commitment made last year, the system of industrial quotas needs to be eliminated at the earliest.

32. **Moreover, as regards customs tariff reform, additional steps could be envisaged,** such as: (i) further reducing the tariff dispersion as the actual dispersion increases effective protection and hampers long-term industrial development; and (ii) moving faster to achieve the authorities' aim of reducing the number of bands from 12 currently, to 5-6.

33. **Notwithstanding the good progress achieved so far in improving the business climate and reducing the costs of doing business, a lot more remains to be done.** Syria still ranks 130 out of 175 countries in the World Bank's *Doing Business 2007* report, and compares unfavorably to other competitors in the Middle East and North Africa region. Removing barriers to competition in product markets and tackling major weaknesses such as the high costs of contract enforcement, trading across borders, starting a business, and property registration can have a large payoff in increasing labor productivity and promoting the Syria's export potential. The authorities are encouraged to speed up the process of adopting the new competition law, and the needed amendments to the company law. The central bank could play a catalytic role in setting up a credit registry.

34. **We wish the authorities success in pursuing their reform agenda,** and thank them for their generous hospitality, their excellent cooperation, and the high quality of the discussion.