January 25, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Final Minutes of Executive Board Meeting 84/18

Page 3 of the final minutes of EBM/84/18 (2/3/84) has been corrected to include the statement on Fiji by the staff representative. Pages 4 and 5 are being reissued to include at the top the lines carried over.

Att: (3)

Other Distribution:
Department Heads

1. FIJI - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Fiji (SM/83/267, 12/29/83; and Cor. 1, 1/4/84). They also had before them a report on recent economic developments in Fiji (SM/84/4, 1/11/84).

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

> The staff would like to update Executive Directors on public sector wage developments, a matter that was subject to considerable uncertainty at the time of the consultation discussions, as explained on page 10 of the staff report (SM/83/267). In December, an arbitration decision on a new wage and salary structure resulted in an increase averaging 7 percent for all government employees. The Government agreed to backdate the award to January 1982. The cost to the 1984 central government budget, net of higher income tax payments, is estimated at the equivalent of 1.5 percent of GDP.

Mr. Ismael made the following statement:

> In 1983, Fiji was faced with two major disasters: a cyclone caused much damage to houses, hotels, and crops, a prolonged drought which adversely affected the sugar crop as well as other agricultural production. As a result of these natural calamities, real GDP declined by 7 percent in 1983. The external account, however, was cushioned somewhat by the drawdown of sugar stocks carried over from the previous year, by the inflow of foreign aid, and by receipts from reinsurance with foreign companies. Since October 1983 normal weather has prevailed. If it continues for the next few months, the outlook for economic growth and external sector developments could be somewhat better than projected in the staff report.
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> Part of the problems faced by Fiji arise from the narrow economic and export base. Almost 70 percent of export receipts are from the sale of sugar, which also contributes directly to approximately 15 percent of GDP. It is an important objective of the Government under the Eighth Development Plan 1981-86 to widen the economic as well as the export base. In the implementation of the Plan, a number of new commodities such as cocoa, timber, fish, ginger, and tropical fruits are being promoted. At the same time, a number of manufactured items are being exported, albeit in relatively small quantities, to Australia and New Zealand under the Sparteca Agreement, which allows free access for a number of commodities produced in Fiji. The authorities are aware that in order to take full advantage of the opportunities provided by Sparteca, domestic costs would have to be kept under tight control, and a flexible exchange rate policy would have to be maintained.
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> Fiji has traditionally followed prudent economic and financial policies. In more recent times, however, some stresses have developed. It is important to understand that Fiji is a small-island economy

isolated from the major world markets. In addition, due to changes in the age structure of the population, there is great pressure on the Government to provide employment opportunities to the rapidly growing labor force. In these circumstances pressures have developed for the Government to play a more active role in infrastructure development and in economic diversification. The public sector, therefore, has assumed a much greater role in the development process and consequently has come to claim a larger proportion of domestic resources.

The Fiji authorities share the staff's concern about the prospects for public finances. The fiscal policy stance until recently has been conservative. In 1981/82, however, there was a sharp increase in the fiscal deficit associated with the implementation of two large capital-intensive projects, the Nadi-Lautoka Regional Water Scheme and the Hydroelectricity Project. With these projects nearing completion in 1983, the fiscal deficit declined from 6.3 percent of GDP in 1982 to 4.2 percent in 1983. The 1984 budget provides for an increase in the deficit to 4.8 percent. Much of this increase is on account of a 19 percent increase in capital programs designed to create employment in drought-affected areas and for agricultural, fisheries, and forestry development. Operating expenditure was budgeted for a modest increase to accommodate the increase in debt service costs. Since the 1984 budget was approved in November 1983, the Government has decided to award salary increases to civil servants based on recommendations by the foreign consultants, Nicol and Hurst. The annual cost of these increases will be $10 million. The cost of backdating salary increases is about $16 million, which, it is intended, will be paid in installments over 18-24 months. The precise impact of these decisions on the 1984 budget outcome and of the outcome of ongoing negotiations for 1983 cost of living adjustments is not clear at this stage. The Government meanwhile has decided to freeze recruitments to the civil service and has established a subcommittee to look for possible savings from departmental budgets already approved for 1984. While it is the declared intention of the authorities to keep the budget deficit within limits approved in the original budget, it seems that achieving this objective will prove difficult and that the actual budget deficit for 1984 could be up to $17 million higher and reach 6.3 percent of GDP, the same proportions as in 1982, if the entire retroactive salary increases are paid in 1984. I would, however, like to bring to the attention of the Board that retroactive salary adjustments arising from the Nicol and Hurst award are a nonrecurring once-for-all expenditure and, if paid in full in 1984, would have no impact on the 1985 budget. In addition, given the high income tax elasticity, the tax system is capable of recovering a significant part of the salary increases awarded to civil servants. The finances of the public enterprises have also been a matter of concern to my authorities, and a special unit is being established within the Ministry of Finance to monitor the activities of these enterprises more closely.

Monetary policy is geared to maintaining external and internal stability and to ensure adequate flows of resources to priority sectors. Given the small and open nature of the economy, it is difficult to completely smooth out erratic monthly movements in the money supply due to seasonal and special factors. At the time of the discussion, the authorities agreed that liquidity growth was somewhat on the high side but by the end of 1983, the rate of growth of the money supply had decelerated somewhat. A smaller rate of increase in liquidity in 1984 is considered appropriate to meet the needs of the economy and to maintain internal and external stability. In recent years credit to the public sector has been growing significantly faster than credit to the private sector because of weak private demand. There is no evidence of the private sector being crowded out; indeed, it is the policy of the Government to borrow abroad in times of tight domestic liquidity rather than to force the private sector out of the domestic market. It is also the policy of the Government to avoid market borrowing as far as possible and to exercise extreme prudence in external debt management.

The external account performance in 1983 was satisfactory in spite of the adverse impacts of the cyclone on the tourist industry and of the drought on sugar crops. The mitigating factors consisted of a considerable reduction of sugar stocks carried from the previous year, the inflow of reinsurance compensation and foreign assistance receipts, all of which helped to cushion against what could have been a difficult situation. Insofar as the balance of payments prospects for 1984 are concerned, the staff is of the view that without policy adjustments, the external current account deficit could increase to an unsustainable level. Since the staff visit in October 1983, the prospects for sugar have improved considerably and it is now expected that the sugar output in the current season could be 50,000 tons higher than what was envisaged three months ago. It is also true that much of the positive impact of higher sugar production on the balance of payments will be offset by the negative impact of higher salaries awarded to civil servants. All in all, therefore, the staff assessment of the prospects for 1984 remains valid. Fiji's medium-term balance of payments prospects, however, are much better. The pine scheme, on which considerable investment has been incurred in the last 20 years, should become an important foreign exchange earner in the latter part of the 1980s. Considerable savings will be made on oil imports from this year with the commissioning of the hydroelectricity project in late 1983. Fisheries exports are also likely to expand considerably. The largest single threat to a viable external position in 1984 and beyond is the large wage and salary increases which have already brought about considerable disparities in income distribution between the urban and the rural sectors and which are likely to strain the public finances and the balance of payments. The proposal to freeze incomes was discussed in depth by the Tripartite Forum made up of representatives from Government, trade unions, and the employers' organization. Regrettably, the idea could not get the support of all parties.

Miss Batliwalla noted that Fiji had traditionally maintained economic and financial policies that had facilitated growth within an open economic system consistent with domestic and external stability. That stability had suffered a setback in 1982 and 1983; the economy was passing through an unsatisfactory phase and the authorities were faced with difficult adjustment choices. Although per capita GDP was relatively high--SDR 1,700--for a developing country, the economy was mainly dependent on sugar exports and tourism, and was thus highly vulnerable to external fluctuations. In 1982, primarily because of the international recession, the growth in GDP had been reversed to minus 1.2 percent. Again in 1983, owing to a cyclone and a prolonged drought, growth prospects had remained dismal: real GDP was expected to decline by about 7 percent. Because of those exogenous developments, the authorities had been unable to meet growth targets set in the Eighth Development Plan or to press ahead with their diversification objectives. Although Fiji had been successful in bringing down inflation in the domestic economy, pressures had developed on the employment side. The revival and diversification of the economy were necessary to solve those problems. She was encouraged by Mr. Ismael's statement that the authorities' objectives under the Eighth Development Plan were to widen the economic and export base and to take advantage of the Sparteca arrangements to promote exports of nontraditional items where Fiji had an inherent advantage.

There was little prospect that pressures on government finances would ease or that the balance of payments position in 1984 would show any sizable improvement, Miss Batliwalla continued. The public sector would have to play an active role in infrastructure development and economic diversification, but she shared the staff's concerns about public finance and the balance of payments. Developments in those two areas would have to be monitored carefully to avoid dissipating the stability gained in earlier years. Quick-yielding capital programs were needed in the drought-affected areas, but the fiscal deficit might have to be moderated, especially by wage restraint and reduced transfers to public enterprises, as well as by savings in departmental expenditures. Demand within the economy in the past two years had been slack, and lack of competition for credit had allowed a large fiscal deficit to be financed comfortably. That situation was likely to change once economic activity and demand picked up, when the authorities might have to borrow abroad to overcome the domestic liquidity squeeze or when the private sector might be crowded out.

Currently, although it had reached the equivalent of 35 percent of GDP, Fiji's external debt was manageable, Miss Batliwalla remarked. A cautious stance was warranted to keep debt under control, and she welcomed Mr. Ismael's assurance that the authorities would exercise extreme prudence in incurring new external debt.

Despite the adversities, the current account deficit had narrowed to 5.2 percent of GDP in 1983 mainly on account of a drawdown of sugar stocks, the inflow of payments on compensation claims, and emergency grant assistance, which were once-and-for-all short-term factors, Miss Batliwalla commented. The external payments situation, however, would remain difficult in 1984. She invited the staff to comment on whether the recent wage increases in the nontrade sector would aggravate the impact of the adverse terms of trade and real effective exchange rate appreciation on the profitability