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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/79

10:00 a.m., May 21, 1984

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. Koné, Temporary
	G. Ercel, Temporary
	G. E. L. Nguyen, Temporary
	J. Delgadillo, Temporary
	J. C. Williams, Temporary
M. Finaish	T. Alhaimus
	T. Yamashita
J. E. Ismael	
R. K. Joyce	L. Leonard
	D. I. S. Shaw, Temporary
	H. A. Arias, Temporary
	W. Moerke, Temporary
	G. Gomel, Temporary
	C. J. Batliwalla, Temporary
	S. El-Khouri, Temporary
	M. Eran, Temporary
A. R. G. Prowse	
G. Salehkhou	O. Kabbaj
	E. I. M. Mtei
M. A. Senior	
	I. Fridriksson, Temporary
	T. A. Clark
	Wang E.

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present
B. Legarda, Consultant. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; J. R. Marquez-Ruarte. Legal Department: Ph. Lachman, J. V. Surr. Middle Eastern Department: A. S. Shaalan, Director; A. K. El-Selehdar, Deputy Director; M. Arif, R. H. Floyd, S. Geadah, K. Nashashibi. Western Hemisphere Department: S. T. Beza, Associate Director; D. L Budhoo, C. V. A. Collyns, E. Hernandez-Cata, Y. Horiguchi, L. R. Kenward, F. Pham. Bureau of Statistics: J. C. O'Connor. Advisors to Executive Directors: S. R. Abiad, S. E. Conrado, Y. Okubo. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. Bulloch, Chen J., V. Govindarajan, H. Kobayashi, J. A. K. Munthali, G. W. K. Pickering, M. A. Weitz.

1. BAHAMAS - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with the Bahamas (SM/84/80, 4/18/84; and Sup. 1, 4/26/84). They also had before them a report on recent economic developments in the Bahamas (SM/84/101, 5/7/84).

Mr. Shaw made the following statement:

My Bahamian authorities are grateful for the excellent and succinct documents which the staff has prepared in connection with the 1984 Article IV consultations. They consider the analysis of policy issues in the staff report to be fair and balanced, and they generally agree with all the main points in the staff appraisal. I can, therefore, be fairly brief in these remarks.

The pace of economic activity continued to improve in 1983. Tourism and manufacturing sector exports grew for the second consecutive year, recovering from the depressed levels of 1981. Agricultural production rose by almost 16 percent after a decline of 20 percent in 1982. The rise in consumer prices eased in line with inflation in the United States, and the current account deficit, at 3.5 percent of GDP, showed a marked drop from the level of 6 percent two years ago. Central bank reserves rose to $123 million or two months of merchandise imports.

My authorities believe that the external environment will remain favorable over 1984-85 and, as a result, they view the medium-term outlook a bit more optimistically than the staff. In particular, they expect that, if the U.S. economy continues to improve, there will be strong growth in tourism and investment. Nevertheless, the Government recognizes that, in view of the sharp increases in the public sector external debt in the past few years, it would be unwise to contract further foreign currency borrowings in order to finance government deficits. The authorities are watching the situation closely and will be prepared to cut back activity in the public sector if the outturn does not prove to be as favorable as they now expect. Two areas in which they are prepared to cut spending are new public sector investment and government employment. In this connection, I would like to point out that the deterioration in the fiscal situation in 1983 was largely the result of unexpected events that should not recur. For example, revenue was not as buoyant as expected because two offshore enterprises failed to make payments under existing agreement with the Government and, in addition, a significant amount of public expenditures spilled over from 1982 into 1983. In order to strengthen the public finances in 1984 and 1985, the Government will concentrate on implementing more efficient methods of revenue collection, particularly arrears of property tax, and curbing current government expenditures. At the same time, capital expenditures will decrease for the second year in a row. This will result in a reduction of the overall public sector deficit to B$27 million or 1.6 percent of GDP.

The staff expresses concern about interest rate policy but notes that the relationship between domestic and foreign interest rates does not pose a major problem at the present time. My authorities agree that there is some relationship between interest rates and capital flows, but they believe that the savings response is not as sensitive as the staff analysis would indicate. The principal savers in the Bahamas are business enterprises and higher income groups. To transfer more real revenue to these savers in the form of higher interest rates would give my authorities some problems. In addition, higher domestic interest rates would cause difficulty in the housing sector. My authorities recognize that their interest rate policy necessitates some controls on capital flows but are not convinced that a big upward adjustment in interest rates would change the savings-investment balance a great deal. However, they are prepared to raise interest rates to whatever level is appropriate to safeguard the balance of payments position and central bank reserves. Such difference as they have with the staff, therefore, is not on the flexibility but on the degree of flexibility that should be employed.

Finally, I would like to comment on the policy of Bahamianization. It is the view of my authorities that this policy has not been a significant factor in impeding direct foreign investment in the Bahamas. The basic objectives of the policy are to ensure that any jobs for which Bahamians are qualified are filled by Bahamians and to protect small local business. In fact, the Government has followed a policy of encouraging substantial foreign investment and it should be noted that most of the large hotels are completely foreign-owned, as are enterprises in the Free Trade Zone. Bahamianization identifies specified areas of business activity which are reserved for Bahamians. These include small retail operations, hotels with less than 20 rooms, taxi services, handicrafts, fishing, and small farms. There is a second category of medium-sized business such as construction, manufacturing for the local markets, and farms up to 500 acres for which there is a requirement of 60 percent local ownership. Other than these categories, there are no restrictions on foreign ownership. My authorities agree, however, that the bureaucratic procedures to approve foreign investment applications need to be streamlined and, in fact, there is a long list of proposals before the Foreign Investments Board. The number of investment applications and the level of foreign investment in the Bahamas compared with its Caribbean neighbors are ample evidence of the attractiveness of the Bahamas for foreign capital. The Government is pursuing an aggressive campaign to bring in foreign investors while at the same time ensuring that potential investment fits with the long-term development strategy of the Bahamas.

In conclusion, I would like to express the gratitude of my authorities to the staff for the extremely useful and constructive round of discussions and for their timely recommendations.

Mr. Clark stated that while the Bahamian economy had displayed some encouraging features in 1983--including a revival of economic activity and a further reduction in inflation--the deteriorating fiscal situation remained worrying. He fully agreed with the staff on the urgency of the fiscal problem and on the appropriate measures for tackling it. A cautious wages policy was important because of its impact both on current expenditures and on wage settlements generally. Wage increases in the public sector had been far above inflation and above comparable settlements in the private sector. The 30 percent wage increase for the water and electricity workers was almost double the increase in prices over the period since end-1980. He recognized that the authorities might be trying to limit the loss of skilled manpower from the public sector, but as unemployment was unofficially estimated at 25 percent of the labor force, he wondered how real that problem might be.

The authorities' decision to reduce electricity prices in 1984 seemed inappropriate, given the rising operating costs of the electricity and other public corporations, Mr. Clark went on. Could the staff or Mr. Shaw comment on that point?

On the external side, the rationale for an exchange rate pegged to the U.S. dollar was understandable, because of the close financial and trade relationship of the Bahamas with the United States, Mr. Clark commented. Nevertheless, in view of the substantial real appreciation of the dollar, he wondered whether a fixed exchange rate was entirely appropriate. The authorities might be forced to adopt increasingly restrictive policies if the dollar remained strong and the exchange arrangements were maintained.

The staff had used measures other than the conventional debt service ratio to indicate the level of external debt, Mr. Clark noted. The ratios included in the paper seemed appropriate as the import content of the major foreign exchange earning activity was so high, but it would have been helpful if a time series of the ratio of debt and debt servicing to GDP had also been included.

He welcomed the fact that the authorities had, in principle, tried to encourage foreign direct investment, Mr. Clark continued. To the extent that capital inflows substituted for the contraction of bank debt, they seemed preferable as a way of financing some of the Government's proposed investment, which inevitably involved some element of risk. He hoped that the authorities would try to reduce any bureaucratic impediments to inward direct investment in the future. Could the staff or Mr. Shaw give an indication of how successful the Free Trade Zone had been in attracting investments? In the light of the staff's comment that the long-term growth of the economy would depend critically on the efficiency of public investment, could the staff indicate its views on the investment appraisal techniques of the authorities?

The staff could have usefully included some tables and charts in its report, Mr. Clark indicated. The staff report should be largely self-contained, and should therefore include the main statistics on developments in the real economy and the financial sector, and on the balance of payments. The problem had been exacerbated in the present case because the report on recent economic developments had not been issued until three weeks after the main report. His authorities had therefore found it difficult to offer their views. He noted the staff's comments about the inadequacy of data in several areas, and he wondered whether Fund technical assistance might not be appropriate. Finally, given the continuing deterioration of the fiscal position, the next Article IV consultation should be held on a 12-month cycle.

Mr. Delgadillo remarked that, despite some apparent improvements in the real sector in 1983 and the maintenance of a low rate of inflation in the past few years, the prospects for the Bahamian economy were not promising. He agreed with the staff that urgent policy changes were necessary to avoid a further deterioration in the public finances. The servicing of the external debt and the growing public sector deficit would continue to exert pressure on the country's international reserves.

The combination of revenue shortfalls, expenditure overruns, and high investment spending was a source of concern, Mr. Delgadillo commented. Clear policy responses were needed to address the situation, and he welcomed the authorities' intention to take vigorous action to cut expenditures and increase revenues. However, the scheduled reduction in electricity rates in 1984 did not appear to match those intentions. Could the staff elaborate on that matter?

Interest rate policy should be geared to the maintenance of an efficient and attractive market, Mr. Delgadillo considered. Domestic market considerations were important, but the authorities should also aim to improve the external sector. Appropriate interest rates would help to regulate inflows and outflows. Furthermore, any signs of crowding out of the private sector could jeopardize the economic potential of the country.

The external debt service ratio of the Bahamas was low by international standards, Mr. Delgadillo went on. However, he agreed with the staff that, in the absence of specific policy action, the outlook was worrying given the projected coincidence of large amortization payments and sizable fiscal deficits.

The staff had commented on the lack of relevant economic data in the Bahamas, Mr. Delgadillo noted. Did that lack of data preclude the possibility of any meaningful analysis of the Bahamian economy and its prospects? Perhaps technical assistance to the authorities in that area could be provided. Finally, he endorsed the staff appraisal.

The staff representative from the Western Hemisphere Department noted that Mr. Shaw had said that the Bahamian authorities believed that the external environment would remain favorable over 1984-85 and that, consequently, they viewed the medium-term outlook more optimistically than the staff. In fact, the staff assumptions were by no means pessimistic. For example, the staff had assumed that the U.S. economy would grow by 4.5 percent in 1984, 3.5 percent in 1985, and 3 percent in 1986. It was expected that inflation would remain at about 4-5 percent, and that the three-month London interbank offered rate (LIBOR) would remain at about 10 percent. Since the staff visit to the Bahamas, interest rates had risen, suggesting that its assumptions might have been on the optimistic, rather than pessimistic, side.

In his statement, Mr. Shaw had referred to the authorities' intention to improve the efficiency of revenue collection, the staff representative noted. The authorities had recently introduced a system of withholding the property tax liabilities of the public sector employees from their monthly salaries, and they hoped that the private sector would follow that example. The property tax arrears were currently estimated at B$60 billion, about one fourth of total taxes collected by the Government in 1983.

With respect to interest rate policy, Mr. Shaw had remarked that the difference in opinion between the Bahamian authorities and the staff was not on flexibility of policy, but on the degree of flexibility that should be employed, the staff representative continued. A fixed exchange rate policy had obvious implications for interest rate policy. Bahamian interest rates could be set at a different level from the U.S. interest rates by resorting to capital controls, but in the long run such a policy was bound to have cumulative adverse effects on the efficiency of the economy.

The authorities were of the view that the policy of Bahamianization had not been a significant impediment to foreign direct investment in the country, the staff representative noted. It was extremely difficult to quantify the effects of such a policy, and the staff was not in a position to say that the policy was impeding investment flows. However, unless there was evidence of market failure, any attempts by the Government to intervene in foreign investment would tend to encourage inefficiency; as a result, unemployment would be higher and output would be lower than otherwise. Given the prospective pressure on international reserves from the public sector, a re-examination of costs and benefits of policies related to private capital inflows might be in order.

Responding to Directors' questions on the reduction of the electricity rate, the staff representative said that in the past three years the Electricity Corporation had invested a great deal, with a view to upgrading the electricity generating facilities and reducing the cost of electricity. It was difficult, from a political viewpoint, not to reduce the rates when there had been reductions on the cost side. The price reduction of 6 percent was not insignificant and the staff foresaw a deterioration in the Electricity Corporation's performance in 1984.

The debt service/GDP ratio in 1983 had been about 3 percent, the staff representative went on. In other words, exports of goods and services from the Bahamas had amounted to between two thirds and three fourths of GDP.

The Government had announced in December 1982 its intention to establish a second Free Trade Zone in New Providence, the staff representative remarked. The first Free Trade Zone was already established in Freeport, Grand Bahama, and the second zone was expected to be operational in mid-1984. It would provide facilities for new labor-intensive manufacturing concerns, such as components assembly, producing exclusively for export. Enterprises operating in that zone were eligible for tax-free imports of raw materials, components, and capital equipment. They would be considered "offshore," and the country would benefit in the form of local value added and fees collected by the Government.

On the investment appraisal techniques used by the authorities, the staff representative said that in many cases the authorities employed management consulting companies to carry out feasibility studies of investment projects.

One of the main problems facing the authorities was the inefficiency of the tax collection system, the staff representative from the Western Hemisphere Department considered. Data on imports were not good, and the authorities did not know whether all import duties were being collected. Recent data on property taxes were also missing. The authorities had problems collecting statistics on national accounts and the balance of payments. Technical assistance from the Fund in those areas would be useful to the Bahamian authorities.

The Deputy Director of the Exchange and Trade Relations Department suggested that some staff papers might include too few charts and tables, while others might include too many. The staff had tried to be flexible in deciding which charts and tables should be included in reports; the overwhelming need in the present case had been to produce a relatively short paper.

Mr. Shaw remarked that the authorities were concerned that the wage increases in the public sector corporations could lead to private sector wage increases. However, they were watching the situation closely to ensure that wages did not get out of hand.

The Bahamian authorities believed that the economy was strong, Mr. Shaw pointed out. The overall public sector deficit was 1.6 percent of GDP, remarkably low by any country's standard. Moreover, revenue forecasts for 1984 had recently been revised upward, and the Hotel Corporation, which had invested heavily over the past two years, was showing a better return in 1984 than had been projected. The authorities believed that they would be able to service the US$150 million Eurocurrency loan without having to reschedule.

In the past month, the authorities had signed an agreement with the United States on the use of radar tracking facilities in the Bahamas that would amount to an additional US$10 million a year in revenues, Mr. Shaw went on. Those payments were retroactive to January 1, 1983.

On interest rates, Mr. Shaw continued, the authorities were looking at monetary policy closely. They agreed that it was not possible to have both a fixed exchange rate policy and a fixed interest rate policy, and they were prepared to raise interest rates as appropriate. The reserves of the Central Bank had increased since the beginning of 1984 by US$60 million. The authorities of the Central Bank were able to monitor developments closely as commercial banks had to apply for any foreign exchange in excess of B$50,000. From those applications, the authorities would have a clear indication of when there might be a run on the reserve position of the Central Bank.

There was little indication of crowding out of the private sector, Mr. Shaw commented. Private sector credit had increased in both 1982 and 1983, although it had declined from the levels reached during 1979-81. Credit to the private sector had increased at a steady rate of more than 9 percent in 1982 and 1983.

On the external side, the Free Trade Zone was designed to encourage foreign direct investment in the Bahamas, Mr. Shaw said. The establishment of a second zone was an indication of the authorities' intention to encourage private foreign investment.

The Acting Chairman made the following summing up:

Directors agreed with the staff appraisal contained in the report for the 1984 Article IV consultation with the Bahamas.

Directors observed that economic activity in the Bahamas had picked up considerably in 1983, particularly in the tourist sector. However, they were concerned about the size of the overall deficit of the public sector, despite the strengthening of the economy. Directors expressed serious reservations about the sizable wage increases granted by the Government and some of the public corporations which were far in excess of the rate of inflation.

Looking ahead, Directors noted that amortization payments on the existing foreign currency debt of the public sector were scheduled to increase substantially. In view of these prospects, Directors urged the Bahamian authorities to act without delay to strengthen the fiscal position and thus to forestall pressures on international reserves. In this connection, Directors noted that efforts needed to be intensified to restrain government spending, especially on wages and salaries. They also recommended a careful review by the Government of the operations of the public corporations, including the pricing of public utilities.

Directors recommended that the Bahamian authorities allow a greater role for market forces in the determination of interest rates and that steps be taken to encourage foreign direct investment.

Directors also underlined the need for close examination of the budgetary implications in evaluating the viability of public sector investment. They also noted that Fund technical assistance might be useful in improving the data base in certain areas.

Finally, Directors encouraged the authorities to keep under close review the appropriateness of the exchange rate.

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

2. PEOPLE'S DEMOCRATIC REPUBLIC OF YEMEN - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with the People's Democratic Republic of Yemen, together with a proposed decision concluding the 1984 Article XIV consultation (SM/84/95, 4/30/84; and Cor. 1, 5/17/84). They also had before them a report on recent economic developments in the People's Democratic Republic of Yemen (SM/84/107, 5/9/84).

Mr. Finaish made the following statement:

Since the country's independence, economic policy in the People's Democratic Republic of Yemen has focused on two main objectives: the transformation of the economy from one dependent on services, mainly connected with the port of Aden, to one directed toward production; and ensuring the basic needs of the population within the framework of a regionally balanced development strategy. In the context of a centrally planned economic system and a series of development plans, a generally strong economic performance has been achieved, particularly between 1975 and 1981. Noninflationary growth was made possible by the successful mobilization of domestic resources--in spite of a severely constrained domestic resource base--and the inflow of workers' remittances, with a contribution also from foreign grants. Substantial progress was made in the buildup of the country's infrastructure, the development of a modern fishing sector, the mechanization of agriculture, and the expansion of social facilities. As a result of these and other policies, an annual growth rate of about 5 percent was realized over the period 1977-81, coupled with a good measure of domestic financial stability and a continued surplus in the overall balance of payments position.

The favorable trend of noninflationary growth has suffered a setback in the last two years owing to the severe floods in 1982 and the drought which followed. These developments have considerably increased the pressures on the country's resources and resulted in a less satisfactory economic performance in 1982-83. Real GDP is estimated to have declined in absolute terms in 1982 as a result of the flood damages, while agricultural output dropped by as much as 28 percent. Output recovered somewhat in 1983 but remained below the level reached prior to the floods and the drought.

During 1982, the pressures on the country's fiscal position intensified in the wake of the floods. The overall budget deficit increased substantially. The increase in the overall government expenditures during the year was accounted for mostly by higher capital outlays associated with the postflood reconstruction as well as ongoing investments envisaged under the current Second Five-Year Development Plan, 1981-85. Current expenditures, however, declined, notwithstanding the large operational and maintenance costs relating to the completed development projects. There was only a marginal increase in domestic revenues, reflecting the direct and indirect effects of the floods on economic activity as well as the process of tax collection.

In order to deal with the emerging difficulties, the authorities adopted in the second half of 1982 a financial stabilization program aimed at promoting the resumption of noninflationary growth, alleviating the pressures on domestic resources through greater control over government expenditures, and containing the current account deficit to a manageable level. The program targets for 1983 were largely achieved and in some areas even surpassed. Despite a lower than expected level of grants, the overall budget deficit was kept at about the same level envisaged in the program. Domestic tax and nontax revenues were higher than expected, while total current and development expenditures were lower than projected. These favorable fiscal developments were accompanied by a much better than expected outcome for the overall balance of payments.

In spite of these improvements, the authorities, aware of the need for continued efforts to improve the fiscal position, have taken a number of measures to reduce the deficit in 1984. On the expenditure side these include (a) maintaining development outlays at below their 1983 level with a reduction in their associated import component, together with a decision to refrain from initiating any new development project unless 75 percent of its cost is financed from foreign sources; (b) a 10 percent cut in current expenditures; (c) further savings in the budgeted allocation for subsidies; (d) continued wage restraint with increased emphasis on incentives to enhance productivity; and (e) improving the efficiency of public sector enterprises, through more flexible pricing policies and the closure of some units found to be inefficient.

On the revenue side, the expectation is that further improvement in tax administration and revenue collection within the framework of the existing tax base will help maintain domestic revenues at a reasonable level. In this regard, it is worth noting that in the past few years domestic revenues have recorded substantial increases both in absolute terms and as a percentage of GNP. Thus, the scope for further significant increases by introducing new taxes or raising existing ones is considered to be somewhat limited. This notwithstanding, the Council of Ministers is expected to consider soon recommendations from a Fiscal Commission and the Finance Ministry regarding ways and means to reduce the deficit further.

One of the effects of the weakening of the fiscal position in 1982 was an acceleration in the rate of monetary growth to 19 percent, from 12 percent in 1981. However, liquidity growth slowed down somewhat in 1983. This was a reflection of the pursuit of financial restraint in that year, as manifested in the containment of the fiscal deficit to about its 1982 level in absolute terms and its decline as a percentage of GNP as well as a deceleration in the rate of growth of credit, particularly government borrowing. Domestic liquidity growth is projected to rise again to about 20 percent during 1984, partly reflecting an increase in credit to the nongovernment sector for investment financing.

In spite of a decline in the current account deficit in 1982, reflecting an increase in workers' remittances and a decrease in imports, the overall balance of payments surplus was well below the levels reached between 1979 and 1981. Tentative estimates indicate a sizable widening of the current account deficit in 1983. The slight increase in exports was overshadowed by a sharp decline in official grants. The recorded overall balance of payments surplus for the year was mainly due to a supplier credit to the Aden refinery. The balance of payments position is expected to remain weak in 1984 as grants and remittances are not expected to register significant increases. These developments make the mobilization of foreign exchange resources a more challenging task than in the past. In their attempt to strengthen the external position, the authorities have taken and are considering a number of short-term and medium-term measures. These include (a) further restraint on imports of certain nonessentials; (b) a halt to new projects except those for which at least 75 percent foreign financing is guaranteed; (c) promoting tourism and improving the services of the national airline company; (d) rehabilitating the country's port facilities; (e) encouraging the production of export commodities that appear to have strong potential, such as coffee and tobacco, through greater emphasis on production incentives and reduction of tax disincentives; and (f) examining the possibilities for oil production and exploitation of other minerals. The authorities are also aware of the importance of workers' remittances to the balance of payments position. However, there are other considerations which need to be taken into account in formulating policies to enlarge the stream of remittances, including domestic labor shortages which, in the past, had resulted from the migration of workers to neighboring countries.

Because of its peg to the U.S. dollar, the currency of the P.D.R. of Yemen has appreciated over the past five years. While the authorities consider the present exchange rate policy to be broadly adequate, it is their intention to keep it under review, taking account of the requirements of the external position and the responsiveness of the major components of the balance of payments to an exchange rate adjustment that can be expected in the context of the country's economy.

In spite of the country's vigorous development efforts over the past decade and the weakening of its fiscal and external positions in recent years, the ratio of the external debt service to current account receipts remains relatively low. This reflects both the authorities' endeavors toward domestic resource mobilization and the fact that the country has been able to obtain most of its foreign loans on concessional terms.

Mr. El-Khouri indicated his general agreement with the staff analysis and his support for the proposed decision. During the past two years, the authorities of the P.D.R. of Yemen had faced a number of adverse circumstances beyond their control, including severe floods in 1982, a drought in 1983 that had continued into 1984, and a decline in foreign assistance. They had moved decisively to limit the adverse impact of those developments on the economy. A financial program had been adopted in connection with the drawing of Fund resources under emergency assistance in 1982. He commended the authorities for meeting the targets under the program.

Despite those efforts, difficult problems remained, Mr. El-Khouri remarked. Production was below potential, the public sector deficit amounted to about 35 percent of GNP, and the current account deficit was about 18 percent of GNP. Furthermore, the prospects for foreign aid and remittances, the two main sources of foreign exchange earnings, did not appear promising.

In view of those difficulties, it was important that the authorities should strengthen their adjustment efforts to prevent a further weakening in the economic and financial situation, Mr. El-Khouri stated. In particular, there was a need to reduce the budget deficit. The present level of domestic bank financing of the deficit, at about 20 percent of GNP, was unsustainable and should also be reduced. Action on both the revenue and expenditure sides would be needed to bring the fiscal situation under control. On the revenue side, he welcomed the establishment of a Fiscal Commission to examine ways in which additional domestic resources could be mobilized. On the expenditure side, further measures were needed to stem the rise in current expenditures, which had grown rapidly in recent years. With respect to development expenditures, he welcomed the recent decision by the authorities not to initiate any new project under the Second Five-Year Development Plan until at least 75 percent of its total cost could be secured from external sources.

Structural adjustment was necessary to strengthen the productive sector of the economy, increase economic efficiency, and improve resource allocation, Mr. El-Khouri continued. Adequate incentives for farmers were a key condition for promoting agricultural production. A review of the appropriateness of the present producer prices might be desirable. A gradual liberalization of the import regime was also advisable to increase the availability of necessary goods, and to encourage and strengthen the development process.

In sum, he commended the authorities for taking the necessary adjustment measures over the past two years to cope with the adverse effects of external developments, Mr. El-Khouri stated. However, large imbalances remained in the economy and the adjustment effort needed to be strengthened. Fortunately, with the present level of reserves, the country could afford to intensify that effort.

Mr. Salehkhou remarked that the economic performance of the P.D.R. of Yemen in the past two years had been severely affected by the 1982 floods that had damaged agricultural infrastructure, reduced output, and adversely affected the country's fiscal and external positions. The setback had been particularly severe as it had coincided with a major deceleration in the growth of the country's two main sources of revenue, the remittances of workers abroad and foreign assistance. The floods had also resulted in the interruption of almost a decade of relatively rapid economic growth, achieved through a sound development program and cautious financial policies. Those policies, supported largely by inflows of highly concessionary capital, had enabled the P.D.R. of Yemen to overcome the constraint of extremely limited resources. The welfare of the population had improved, infrastructure had expanded, and the structure of the economy had been transformed toward one based on commodity production.

The authorities, with the assistance of foreign donors and international organizations, had reacted rapidly to the disaster, in an attempt to contain the adverse effects, Mr. Salehkhou observed. The Fund had also participated in the emergency efforts and had encouraged the country to concentrate not only on the rehabilitation of the economy but also on the correction of its financial imbalances and structural weaknesses.

It was encouraging to note that most of the objectives set in the financial program for 1983 had been met, particularly with respect to public finances and liquidity creation, Mr. Salehkhou went on. It should also be noted, however, that substantial imbalances remained and that the growth of GDP had been below target in 1983 following the large decline recorded in the previous year. While there seemed to be large differences of opinion between the staff and the authorities about policy instruments, perhaps owing to the centrally planned nature of the economy, further action was clearly needed to restore the potential for growth and development in the P.D.R. of Yemen.

The original targets of the Second Five-Year Development Plan for 1981-85 were obviously unattainable after the 1982 disturbances and the related shortfalls that forced a reduction of public investment, including a ban on the implementation of many new projects, and the reorientation of development priorities toward reconstruction, Mr. Salehkhou commented. On financial policy, the large budget deficit and its financing through recourse to bank credit were matters of concern. The authorities should try to mobilize greater domestic resources. They had appropriately revised downward the original budget estimates for 1984 to allow for some increase in tax and nontax receipts and for additional cuts in current and capital expenditures. Nevertheless, the deficit for 1984 was still estimated at more than 35 percent of GDP, while central bank financing should increase to 21 percent of GDP. Those developments would adversely affect inflation, particularly given the extensive price controls. Furthermore, the economy's structural problems would be increased.

Despite an overall balance of payments surplus in 1983, compared with the relatively large deficit projected under the program, the current account and overall deficit seemed to be increasing rapidly, and the two main sources of foreign exchange showed no signs of recovery, Mr. Salehkhou went on. The authorities seemed aware of the difficulties and were implementing appropriate measures, such as restraining imports of nonessential goods, scaling down public investment, promoting tourism, providing incentives for export production, and intensifying oil exploration, to deal with the deterioration of the external accounts. However, the measures would have only a limited impact on external imbalances in the short term.

The authorities of the P.D.R. of Yemen should be commended for their vigorous development efforts and generally cautious financial policies, Mr. Salehkhou stated. But even stronger measures were clearly needed to cope with their present difficulties and to restore the development growth that the country had enjoyed in the previous decade. Finally, he could support the proposed decision.

Mr. Finaish remarked that the economy of the P.D.R. of Yemen had been improving over the past five years. However, the floods of 1982 and the following drought had been a major setback. The authorities faced a challenging task, in particular, the mobilization of foreign resources. The traditional sources of foreign exchange were drying up: the oil refinery had become less competitive relative to more modern facilities in the region; remittances were declining owing to reduced demand for labor in the area, lower wage differentials, and a shortage of labor in the P.D.R. of Yemen; and foreign aid had been reduced. Even the IDA allocation for the P.D.R. of Yemen would decline by $5 million between 1983/84 and 1984/85, an amount that was disproportional to the reduction in the funding of IDA.

The authorities were taking appropriate action in many areas, although their emphasis on interest rates and exchange rates differed from that of the staff, Mr. Finaish continued. They would continue to keep those two instruments under review, but they were not as sure as the staff about the degree of effectiveness of those instruments in the present circumstances, and would put more emphasis on improving the quality of banking services. With respect to the exchange rate, the authorities felt that their room for maneuver was limited; the country produced only a few goods for export and the possibilities of export diversification and import substitution were relatively limited, particularly in the agricultural sector where the lack of water resources constituted a major constraint. Nevertheless, the authorities had introduced some incentives for agricultural production. Pricing policy had been liberalized, seven of the state farms had been closed, and important measures had been introduced to encourage cotton cultivation.

The Acting Chairman made the following summing up:

Executive Directors were in general agreement with the staff appraisal in the report for the 1984 Article IV consultation with the People's Democratic Republic of Yemen. The economy suffered a severe setback in 1982 owing to strong floods and a subsequent drought that damaged infrastructure and lowered growth prospects over the medium term. Directors noted that, partly as a result of the deceleration in output growth that ensued and partly owing to structural shifts in the economy, the fiscal and balance of payments positions had deteriorated since 1982. In the fiscal area there was a slowdown in the increase in revenues and a rapid rise in expenditures, resulting in a sharp increase in central bank financing of the deficit. Directors commended the authorities for containing the deficit in 1983 to the targets set in the financial program prepared in connection with the emergency purchase from the Fund related to the natural disaster. However, they expressed concern regarding the size of the projected bank financing of the deficit for 1984 and the inflationary pressures that might ensue. The fiscal position was unsustainable, and Directors urged the authorities to take the necessary further measures to strengthen the public finances.

After several years of surpluses, the balance of payments moved into a deficit position in 1983 with a higher deficit forecast for 1984. The growth in remittances from Yemenis working abroad has decelerated and may decline, while foreign aid has been declining since 1982. Directors expressed the hope that the authorities would take appropriate measures to strengthen producers' incentives and the competitiveness of the economy with the objectives of promoting traditional sources of foreign exchange earnings as well as new exports and stimulating the production of import substitutes. Directors welcomed the measures that the authorities had taken or were considering to strengthen the external position. The prospect of declining foreign assistance also makes it urgent for the authorities to strengthen domestic resource mobilization.

It is expected that the next Article IV consultation with the People's Democratic Republic of Yemen will be held on a standard 12-month cycle.

The Executive Board then took the following decision:

Decision Concluding 1984 Article XIV Consultation

1. The Fund takes this decision relating to the exchange measures of the P.D.R. of Yemen subject to Article VIII, Sections 2 and 3, and in concluding the 1984 Article XIV consultation with the P.D.R. of Yemen, in the light of the 1984 Article IV consultation with the P.D.R. of Yemen conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The P.D.R. of Yemen continues to maintain a comprehensive system of controls on payments and transfers for current international transactions. The Fund hopes that the authorities will take appropriate measures which would enable them to simplify the system.

Decision No. 7706-(84/79), adopted
May 21, 1984

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/78 (5/16/84) and EBM/84/79 (5/21/84).

3. EASTERN CARIBBEAN CENTRAL BANK - HOLDER OF SDRs

1. Prescription as a Holder

With effect from October 1, 1983, the Eastern Caribbean Central Bank ("the Bank") is prescribed in place of the Eastern Caribbean Currency Authority ("the Authority") as a holder of SDRs in accordance with Article XVII, Section 3(i) of the Articles of Agreement.

2. Change of Ownership of SDRs Held by the Authority

The records of the SDR Department shall indicate that as of October 1, 1983, the Bank acquired title to all SDRs held by the Authority.

3. Terms and Conditions for Acceptance, Holding and Use of SDRs

The Bank is authorized to accept, hold and use SDRs in transactions and operations in accordance with and on the terms and conditions specified in the Decision "Terms and Conditions for the Acceptance, Holding, and Use of SDRs by Other Holders

Prescribed Under Article XVII, Section 3" (Decision No. 6467-(80/71) S, adopted April 14, 1980), as amended from time to time. (EBS/84/108, 5/9/84)

Decision No. 7707-(84/79) S, adopted
May 17, 1984

4. RELATIONS WITH GATT - CONSULTATION WITH CONTRACTING PARTIES - FUND GUIDANCE

The Executive Board agrees to the proposed guidance statement for the Fund representative at the forthcoming balance of payments consultations on Hungary with the CONTRACTING PARTIES to the GATT, as set forth in EBD/84/122, Supplement 2 (5/17/84).

Decision No. 7708-(84/79), adopted
May 18, 1984

5. ISRAEL - RELEASE OF INFORMATION

The Executive Board approves the proposal set forth in EBD/84/139 (5/14/84) regarding the transmittal of the report on recent economic developments in Israel (SM/84/103, 5/8/84) to the CONTRACTING PARTIES to the GATT.

Adopted May 16, 1984

6. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 83/185 and 83/186 are approved. (EBD/84/138, 5/11/84)

Adopted May 17, 1984

b. The minutes of Executive Board Meetings 84/1 and 84/2 are approved. (EBD/84/140, 5/14/84)

Adopted May 18, 1984

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAP/84/104 (5/16/84), is approved.

APPROVED: November 15, 1984

LEO VAN HOUTVEN
Secretary