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Minutes of Executive Board Meeting 84/97

3:00 p.m., June 20, 1984

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. Koné, Temporary
	L. E. J. M. Coene, Temporary
	G. E. L. Nguyen, Temporary
	M. A. Weitz, Temporary
	M. K. Bush
M. Finaish	T. Alhaimus
	H. Kobayashi, Temporary
J. E. Ismael	Jaafar A.
	D. I. S. Shaw, Temporary
	C. Robalino
G. Laske	
	N. Coumbis
	V. Govindarajan, Temporary
	J. E. Suraisry
J. J. Polak	T. de Vries
	H.-S. Lee, Temporary
G. Salehkhou	
	S. M. Hassan, Temporary
M. A. Senior	
	A. K. Juusela, Temporary
	T. A. Clark
	J. Bulloch, Temporary
Zhang Z.	

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

Joseph Waight, Ministry of Finance, Belize; Henry Cain, Ambassador of Belize to the United States. B. Legarda, Consultant. Central Banking Department: S. P. Leite. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Kanesa-Thasan, M. Nowak. Fiscal Affairs Department: A. H. Mansur, J. S. Porras. IMF Institute: A. Al-Saghan, Participant. Legal Department: A. O. Liuksila, J. K. Oh. Middle Eastern Department: P. Chabrier, Deputy Director; J. G. Borpujari, M. Hosny, G. Tomasson, L. A. Wolfe, M. Yaqub. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; A. Baumgarten, M. E. Bonangelino, A. Caetano Filho, A. Cheasty, J. Fajgenbaum, M. E. Hardy, S. N. Kimaro, A. Lopez-Claros, S. J. Stephens, E. C. Suss. Advisors to Executive Directors: S. R. Abiad, H. A. Arias, D. C. Templeman. Assistants to Executive Directors: H. Alaoui-Abdallaoui, I. Angeloni, R. L. Bernardo, M. B. Chatah, G. Ercel, D. Hammann, M. Lundsager, J. Reddy, D. J. Robinson, A. A. Scholten, Shao Z.

1. BELIZE - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Belize (SM/84/113, 5/17/84; Cor. 1, 5/31/84; and Sup. 1, 6/18/84). They also had before them a staff report on recent economic developments in Belize (SM/84/126, 6/5/84).

Mr. Joseph Waight, of the Ministry of Finance of Belize, and Mr. Henry Cain, Ambassador of Belize to the United States, were also present.

Mr. Shaw made the following statement:

My authorities would like to express their appreciation for the excellent documents that the staff has prepared in connection with the 1984 Article IV consultation with Belize. They consider the analysis in the staff report to be fair and balanced and are in general agreement with the advice proposed by the staff in the appraisal.

Economic activity in the Caribbean Basin has been depressed over the past few years, and the Belizean economy has not escaped. Belizean economic activity has also been further influenced by the global recession and the situation in Mexico. Nevertheless, the economy began to recover in 1983 and posted a real increase in output of 2 percent, led by growth in merchandise exports of almost 9 percent. This recovery is all the more remarkable, given that exports had declined by nearly 20 percent in 1982. While recovery is not assured, the agricultural sector, which accounts for over 20 percent of GDP and more than 70 percent of exports, continued to grow in 1983 by 2.3 percent. Consumer prices increased by only 2.7 percent, in line with inflation in the United States, and the current account deficit, at 6.9 percent of GDP, showed a marked drop from the level of 11.1 percent in 1982.

These indicators of economic recovery do not detract from the fact that the public sector financial situation remains weak. My authorities are well aware that the immediate priority must be to reduce the deficit in the fiscal accounts. Central government revenues declined in 1983/84 in relation to GDP as the economy weakened and foreign trade transactions declined. This decline took place in spite of an increase in customs duties in each of the past four fiscal years, an increase in the stamp duty on imports in 1982/83, and a revenue-replacement duty affecting imports introduced in 1981/82 and subsequently increased. Recognizing this heavy dependence on trade-related taxes, the Government is giving priority to strengthening the collection of other taxes, particularly income taxes, and to restraining the overall growth in public expenditures. In this respect, the newly established Office of Budget and Management has helped to modernize the accounting and budgeting procedures in the Central

Government and the authorities intend to extend these procedures to the entire public sector. The Fund's technical assistance in this area has been particularly helpful. The concern of the authorities has also been demonstrated by the restraint on public service wages. There has been no general increase since 1981, and the budget for 1984/85 assumes no general increase in salaries and the elimination of most vacant positions.

In spite of the measures taken in the past to improve the fiscal position of the Central Government, the authorities agreed with the staff that substantial additional fiscal measures would be needed to reduce the public sector deficit to more manageable levels. As a result of the Article IV consultation and the recommendations of the staff during these consultations, the authorities implemented additional revenue measures on June 15, 1984, as detailed in the supplement to the staff report. It is important to point out that all of these revenue measures are consumption taxes and will, in addition to improving revenues by BZ$12.5 million, contain domestic demand. I should also like to emphasize the determination of the Government to have public enterprises operate on a more financially sound basis, and the increases in the rates for electricity and water are a major step to this end.

My authorities intends to continue pursuing conservative monetary policies. They agree with the staff that it will be important to stimulate private savings, and they will therefore continue to follow a flexible interest rate policy. However, they believe that any increase in interest rates at this time would result in only modest growth in savings. It is also important to note that the private sector is active and well developed and the authorities feel that the present level of interest rates is needed to revive investment activity in this sector.

The Government remains concerned about the external financial position and hopes that the correction in the fiscal deficit will be reflected in the current account balance. They agree that it will be important to avoid a loss of reserves in 1984, and, in fact, by law, the Central Bank must not reduce reserves below their present level. My authorities believe that the peg of the Belize dollar to the U.S. dollar is appropriate. As the staff point out, the trade-weighted real effective exchange rate remained relatively stable in the 1976-80 period and appreciated by some 15 percent in 1983 as a result of the U.S. dollar appreciation. My authorities believe that an adjustment in the exchange rate at this time would not increase the competitiveness of exports, as most export sales are to the United States. It should also be noted that the U.S. dollar circulates freely in the Belizean economy and constitutes a significant portion of the money supply.

Finally, I would like to draw Director's attention to the external sector. Belize does not restrict either current or capital transactions, and there has been no intensification of trade restrictions since 1982. This open trading system has been maintained in spite of the recession. Recognizing that import restrictions would not be beneficial to Belize, the authorities are considering the elimination of these restrictions and their replacement by moderate tariffs. These trade liberalization measures would represent a major step by the authorities, given the openness of the Belizean economy. I should also like to point out that Belize accepted Article VIII status and became a full member of the GATT in 1983.

In conclusion, my authorities have indicated their wish to enter into negotiations with the Fund for a stand-by arrangement. Given the measures already taken and described in the supplement, as well as the authorities' intention to take additional measures to correct any imbalances, I would hope that the request by Belize will command the support of the Fund. My authorities are particularly grateful to the Fund staff for advice and recommendations.

Mr. Robalino stated that he could endorse the staff appraisal. Despite world economic difficulties over the past several years, the Belize authorities had demonstrated their willingness to adopt measures to reduce pressures on their balance of payments. Confronted by a substantial deterioration in the terms of trade during 1981 to 1983, the authorities had made successful efforts to improve the current account of the balance of payments during the past year, in absolute terms and in relation to GDP, by no means an easy task for any country. Because the net inflow of capital had declined drastically from the high level reached in 1982, the overall balance of payments position did not reflect the improvement of the current account, not an unusual occurrence in a developing country.

However, the measures adopted by the authorities had not been sufficient to halt the deterioration of the fiscal position, and further efforts were required, Mr. Robalino continued. In that respect, he welcomed the adoption of the recent measures described in Supplement 1 to the staff report. Clearly, Belize's current financial difficulties stemmed in large part from structural maladjustments in the public sector that had impeded the improvement of public finances. It would be prudent for the authorities, in the interests of a sound economy, to take prompt measures to make the customs administration more effective as well as to improve the management and efficiency of the state enterprises, which were coming under increasingly severe financial pressures. Such measures would help to supplement the efforts needed to restrain expenditure in order to curb the growing public sector deficit. In that connection, he attached great importance to the necessity of resistance on the part of the authorities to any wage increases that might push current expenditures beyond their present high level. He welcomed the new measures taken by the Belizean authorities but noted that for the fiscal year 1984/85 a gap of about 5 percent of GDP still had to be financed. The authorities had shown determination in their adjustment efforts, but he wondered how much further they could go in order to cover the remainder of the financing gap.

The external debt of Belize was not a matter for immediate concern, Mr. Robalino considered, although its structure should be watched carefully. The authorities should exercise prudence in contracting commercial debt, which appeared to have grown rapidly in the past few years.

The exchange rate policy followed by the authorities had resulted in an appropriate exchange rate for the Belize dollar, Mr. Robalino remarked. Primary exports had remained competitive, and the authorities should take advantage of their favorable position to persevere with their current policy of granting incentives to export-oriented industries. In that way, Belize would again benefit in the U.S. market, under the Caribbean Basin Initiative, and in other markets as well.

Finally, Mr. Robalino said, he welcomed the fact that Belize had refrained from intensifying its exchange restrictions, that it had accepted the obligations of Article VIII of the Fund's Articles of Agreement, and assumed the status of a contracting party to the GATT.

Miss Bulloch observed that Belize had a small and relatively open economy, which was heavily influenced by external economic developments. It was therefore important for the authorities to pursue policies that would boost the economy's resilience to any external shocks or would at a minimum avoid compounding their effect.

She welcomed the mention in the supplement to the staff report of the authorities' wish to enter into negotiations with the Fund for a stand-by arrangement, Miss Bulloch remarked. Such an arrangement would be an appropriate way of reinforcing and carrying forward the measures already taken to improve the public finances and external position. The usual medium-term projections of the balance of payments and of external debt, which were missing from the staff reports, might have given a useful illustration of the economy's vulnerability to external developments as well as indicated how soon a return to a sustainable external position could be expected. She recognized the constraints on the availability of data in Belize. All the same, if the staff did present the Executive Board with a request from Belize for a Fund-supported program, it should include such projections. It would also be interesting if the staff could undertake a sensitivity analysis based on the prospects for world sugar prices.

Fiscal restraint was the key to reducing the internal and external imbalances in the economy of Belize, Miss Bulloch considered. The measures introduced in 1984/85, together with the additional revenue measures described in the supplement to the staff report, were an important first step. The implementation of those supplementary measures would halve the unfinanced gap in the public sector accounts that the staff had projected for fiscal year 1984/85. However, if account were taken of arrears, the gap would still be projected at about 5 percent of GDP. Like Mr. Robalino, she would interested in the views of Mr. Shaw and of the staff on how that gap might be financed, or alternatively on the additional measures of adjustment that would be required to eliminate it.

She joined the staff in encouraging the Belize authorities to intensify their efforts to improve the management and efficiency of the public enterprises, Miss Bulloch went on. She noted that electricity and water rates had been increased in the supplementary budget. It seemed appropriate to pass on to the consumer the increase in the cost of the Electricity Board's fuel inputs, although the reason for the 33 percent increase in the water rate was less clear.

The description on pages 11 and 12 of the staff report of the authorities' view of the appropriate way to maintain existing lending from the commercial banks to the public sector was interesting, Miss Bulloch considered. The authorities' preference was to use moral suasion to encourage commercial banks to hold treasury bills, rather than to change their present interest rate policy. The staff had recommended the restoration of the premium of domestic rates over international rates in order to promote the attention of private financial savings. However, the resulting capital inflows might boost domestic bank liquidity and have adverse inflationary consequences. On the other hand, according to Table 1 of SM/84/113, there had been a substantial reversal of private capital flows in the past two years. The case for increasing interest rates might be stronger, if there seemed to be a danger of capital flight.

She had not been altogether convinced by the argument in Mr. Shaw's statement that the appreciation of the Belize dollar in line with the U.S. dollar had had no significant effect on export performance, Miss Bulloch remarked. It was true that a large proportion of Belize's exports were to the U.S. market, but she wondered how far Belize was competing in that market with suppliers whose currencies had depreciated against the U.S. dollar. She agreed with the staff that the preservation of cost competitiveness was important for the future promotion of exports. She also welcomed the consideration being given by the authorities to replacing existing import restrictions with tariffs, and she hoped that they would soon be in a position to press ahead in that direction.

Finally, Miss Bulloch supported the staff in urging caution on the authorities in the contraction of new external commercial credit.

Ms. Bush welcomed the opportunity to review the staff report for the second Article IV consultation with Belize, showing that in 1983 the overall economic situation had improved. That was evident in the reduction in the current account deficit from its high in 1982, the substantial decline in the inflation rate, and the return to real economic growth.

She agreed with the recognition in the staff appraisal that Belize had been seriously affected by events beyond its control in the international economy. However, since those events might not be substantially reversed in the near term, it was necessary for the Belizean authorities to adjust promptly to the new international environment.

In particular, the large fiscal deficit presented a serious problem, Ms. Bush considered. While her authorities had been pleased to note the new fiscal measures introduced within the past week, which were projected to halve the unfinanced gap reported in the staff report itself, the remaining unfinanced component of the fiscal deficit led them to fear that planned decreases in payments arrears might not occur, or that Belize might increase its foreign borrowing. Belize's debt service remained manageable, even low in comparison with other developing countries, but as the staff had noted, the recent increase in commercial borrowing, if it were not contained, could lead to problems within the next several years.

On a related point, Ms. Bush went on, the staff had suggested in its appraisal that price adjustments by the public enterprises should be used to raise revenues, yet it was not clear to what extent those prices failed to reflect the costs of production, other than by implication in the form of the reported size of the aggregate deficit of public enterprises. Her authorities would encourage the Belize authorities to raise prices to reflect, to the extent possible, true operating costs.

The Belize authorities' commitment to increasing the role of market forces in such areas as rice production and meat processing was welcome, Ms. Bush remarked. She also endorsed the warning in the staff report against major government involvement in the sugar industry. In addition, she commended the authorities for maintaining an open trade and exchange system and for what appeared to be appropriate priorities relating to the promotion of growth and to increasing the value added in export sectors, particularly in the agricultural sector.

In conclusion, Ms. Bush commented, the lack of complete data in Belize on economic activity, including the balance of payments, presented the staff with understandable difficulties. She encouraged the Government of Belize to extend its efforts to improve accounting procedures in the fiscal sector, as well as to develop comprehensive methods for keeping balance of payments records.

The staff representative from the Western Hemisphere Department noted that the yield from the welcome fiscal measures that had recently been adopted should be approximately equivalent to half the identified financing gap. The staff intended to review, with the officials from the Ministry of Finance of Belize who were currently in Washington, both the details and the impact of those measures as well as other possible ways of closing the remaining financing gap. During the consultation discussions, the Belize authorities had felt that if they undertook significant action to close the gap, especially in the context of a possible program with the Fund, additional means of closing the gap might be opened up.

For instance, one possibility might be a rescheduling of some of the existing arrears, which comprised debt to commercial banks--including the debt of branches of foreign commercial banks--as well as suppliers' credits. In addition, of course, the authorities would have to review their expenditure policy and consider possibilities for further adjustments to the prices of public enterprises.

The increase in water and electricity rates had been made, according to the understanding of the staff, in light of the operating deficits faced by the enterprises, the staff representative continued. It might be necessary for other enterprises to increase their rates as well.

It had unfortunately not been possible to make medium-term projections, the staff representative explained, partly because of the difficulty with the data. However, it would of course be important to make such predictions if the staff entered into negotiations with the authorities on a program under a stand-by arrangement.

While there had been some reflow of capital in 1983, the staff representative noted, its source was difficult to identify, partly because errors and omissions were included in the figures of the capital account of the balance of payments. Such short-term developments as those relating to recent events in Mexico might have led to some inflow that was not a true reflection of market conditions in Belize. Thus, the staff had felt that Belize needed to increase its interest rates in order to improve its competitive position vis-à-vis the rest of the world and to encourage further the growth of domestic savings.

Mr. Shaw observed that, as he had mentioned in his opening statement, it was not clear to the Belize authorities that an increase in interest rates would at the present time lead to an increase in domestic savings. Furthermore, as shown in Table 37 of the report on recent economic developments, interest rates were positive in real terms. Lending rates were 14-15 percent and rates on time deposits were 10 percent; with inflation running at well below 10 percent over the past two years, those rates should offer a sufficient incentive for domestic savings. Although remittances from abroad were substantial, they did not depend on the interest rate differential, but were the result rather of moral suasion on Belizean nationals to remit funds that were subsequently used almost entirely for consumption.

The medium-term outlook for the economy would of course be discussed if the staff and the Belize authorities entered into negotiations on a program with the Fund, Mr. Shaw remarked. The Government of Belize was concerned about the investment program and the need to diversify the export sector. The Prime Minister, in his recent budget speech, had listed a number of projects that were under consideration, focusing inter alia on initiatives in the agricultural sector, for instance, to breed livestock and to expand the growth of citrus crops, as well as to develop small industries and to increase tourist facilities. The authorities' intention was to finance many of those projects through development aid, with a minimal amount of commercial borrowing abroad. His authorities were aware of the country's external indebtedness, which was a matter of concern to them.

As a result of the courageous measures recently adopted by the authorities, which were to be supplemented by other measures, Mr. Shaw continued, half the fiscal gap, amounting to approximately BZ$32 million, would be filled. The remaining gap would not be great if Belize were able to make use of the Fund's resources in an amount of up to BZ$10 million.

As he had mentioned in his opening statement, Mr. Shaw added, the Belize authorities saw no need for an exchange rate adjustment at present. The sugar industry in Belize was privately owned and was highly competitive. Sugar exports, which accounted for a large share of Belize's exports, had been affected more by quotas on sugar imports to the United States than by the upward movement of the U.S. dollar.

Finally, Mr. Shaw noted, as the Prime Minister had stated in his budget speech, "in the circumstances, the Government has decided to establish a relationship with the IMF at an early stage in order to prevent a devaluation of our currency at a later date when the situation is expected to worsen, and would require harsher and more painful measures." That type of attitude, on the part of a country like Belize, with a small, open economy, should command the support of the Fund.

The Acting Chairman made the following summing up:

> There was broad agreement with the views expressed in the staff appraisal contained in the report for the 1984 Article IV consultation with Belize.
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> Directors observed that the pace of economic activity in Belize had slowed in the past few years in reflection of world market conditions. In 1983, however, there had been some recovery of economic activity, which Directors welcomed, especially since it had been accompanied by a very modest pace of price increases. Directors nevertheless expressed concern about the increase in the overall deficit of the public sector that had taken place in recent years, and they noted that the overall balance of payments had registered a substantial deficit in 1983, notwithstanding a significant improvement in the current account balance.
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> Directors observed that the public sector deficit had been expected to increase further in 1984/85, and thus they welcomed the important revenue measures just adopted by the Belizean authorities. Directors recognized that those measures constituted a significant step toward the strengthening of public finances, but they noted that further efforts might be required to close the prospective financial gap. They emphasized that the strengthening of public sector savings was necessary to achieve and support an appropriate investment effort. The importance of the efforts

being made to improve fiscal management and budgeting and customs procedures was stressed by Directors, who recommended that the authorities extend these efforts to the public enterprises and pursue realistic pricing policies for public services.

Directors noted the emergence of payments arrears on the part of the public sector during the past fiscal year and urged that they be eliminated as soon as possible. They welcomed the authorities' policy of wage restraint for the civil service and recommended that this policy also be applied in the public enterprises.

Directors noted that the authorities had been pursuing a flexible interest rate policy. Such an approach would help to promote private financial savings and to reduce pressures on the balance of payments.

Directors observed that the exchange system of Belize has remained free of restrictions and supported the planned conversion of existing trade restrictions into tariffs.

Directors urged the authorities to keep under close review the appropriateness of the exchange rate, stressing that cautious demand management policy would be of the essence in order to maintain the present exchange system. Particularly in such an open economy, it was important to remain competitive. The authorities were also encouraged to exercise prudence when contracting external debt.

Finally, Directors noted the intention of the Belizean authorities to enter into negotiations with the Fund for a stand-by arrangement. In this connection, the staff was asked to provide a medium-term balance of payments assessment in future reports to the Board.

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

2. UNITED ARAB EMIRATES - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with the United Arab Emirates (SM/84/98, 5/2/84). They also had before them a report on recent economic developments in the United Arab Emirates (SM/84/120, 5/24/84; and Cor. 1, 6/11/84).

Mr. Finaish made the following statement:

Economic policy in the United Arab Emirates continues to be guided by two main objectives. The first is to adjust gradually the level of government expenditures to one that can be sustained by the reduced flow of revenue from oil and gas exports. In undertaking that adjustment, the authorities are mindful of the need to avoid any undue pressures on the domestic economy. The second objective is to strengthen the structure of the U.A.E. economy in a manner which can lead to a more balanced and stable growth in the longer run. For that purpose the authorities are continuing their efforts to improve resource allocation, upgrade and utilize more fully the domestic labor force, and broaden the productive base to the extent feasible. Economic cooperation between the United Arab Emirates and other members of the Gulf Cooperation Council (GCC) can play a useful role in this regard.

In the face of continued decline in revenues from oil and gas exports, and in line with the policy of fiscal restraint adopted since 1981, government expenditures in 1983 were further curtailed by about 16 percent. This reflected cuts in both current as well as development expenditures. The former included a reduction in subsidies resulting from the increase in the prices of petroleum products to commercial levels in March 1983 and the elimination of the food subsidy. In addition, subsidies for electricity, university education, and youth care were reduced by 30 percent in early 1984. The reduction in development expenditure reflected to a large extent the completion of major projects, particularly in electricity, education, and health care, in addition to increased scrutiny in the process of project selection. The combined effect of these and other expenditure cuts on the one hand, and a 22 percent drop in revenue on the other, resulted in a consolidated budget deficit to about 5 percent of GDP. Although this deficit was larger than the one experienced in 1982, the fiscal position in 1983 was actually more contractionary. This is because, given the structure of the U.A.E. economy, the impact of fiscal operations on domestic liquidity and on economic activity in general is more appropriately measured in terms of net domestic expenditure--i.e., domestic expenditure minus domestic revenue--which dropped appreciably in 1983, rather than the overall budget balance.

The contractionary impact of fiscal policy in 1983 was transmitted to all sectors of the economy. Both non-oil GDP and the price level registered small declines after increasing by 7 percent and 8 percent, respectively, in 1982.

In the monetary sector the fiscal developments and the ensuing general slowdown in economic activity were translated into a substantial deceleration in domectic liquidity expansion and the rate of growth of claims on the private sector. At the same time, the general position of the commercial banking system showed marked improvement, as manifested in the strengthening of banks' liquidity and reserve positions. While this is true in the aggregate, the authorities are aware that in certain cases, particularly in small banks, there is a need to improve the asset and liability structure further. This is viewed as part of the ongoing effort by the central bank to strengthen its role in the supervision and regulation of commercial banks. Toward that objective, improved reporting procedures were instituted early last year which allowed closer monitoring of domestic banking operations as well as a more effective evaluation of country and currency risks in bank portfolios. In addition, central bank authorization was required prior to the payment of dividends by banks as a means of ensuring that adequate reserves were being maintained against bad debts.

Developments in the U.A.E. balance of payments in 1983 reflected both the decline in revenue from oil and gas exports and the cuts in public sector expenditures. In the current account, a drop in imports and in transfers abroad, both private and official, partially offset the decline in exports and investment income and helped to maintain the current account in surplus, though a much smaller one than in recent years. The capital account, on the other hand, showed a decrease in net capital outflow in 1983, which was partly due to a shift in quasi-monetary deposits in favor of domestic commercial banks.

Projections for 1984 indicate a likely reversal of the downward trend in the current account surplus experienced since 1980. The expected increase in the surplus is based on the assumptions of little or no change in revenue from oil and gas exports and an overall budget deficit of the same magnitude as in 1983. Moreover, imports and transfers are expected to decline somewhat because of the continued restraint in fiscal policy, while net investment income is expected to show some increase in view of interest rate movements abroad.

Finally, in spite of the general policy of fiscal restraint and the slowdown in economic activity since 1981, the United Arab Emirates has continued to play an important role as a source of assistance and finance to other countries both within and outside the region. This has taken the form of official grants and loans, substantial workers' remittances, as well as private capital flows. Although the magnitude of these flows was inevitably affected by the policy of fiscal adjustment pursued in the last few years, the authorities have continued to allocate a significant portion of government revenue for external assistance in the form of grants and loans. Indeed, measured as a proportion of net oil receipts, external assistance was higher in 1983--at 14 percent--than in 1980, when net oil receipts had been twice as great.

Mr. Suraisry observed that during the past two years, the United Arab Emirates had experienced a sharp decline in its export earnings and budgetary receipts due to the weakening of the international oil market.

The authorities had reacted to those developments in a prudent and responsible manner. Government expenditures had been reduced in order to alleviate pressures on resources and the balance of payments, but the reductions in spending had been gradual so as not to disrupt the economy. In that respect, the conduct of fiscal policy had been similar to that of other members of the Gulf Cooperation Council (GCC). By following such policies, the members of the GCC were continuing to contribute effectively to the international adjustment process.

In general, fiscal policy had been helpful in stabilizing the economy, Mr. Suraisry continued. Current expenditures had been reduced, mainly through a virtual elimination of subsidies on petroleum products. Furthermore, tariffs in the government sector had not been increased either in 1982 or in 1983. The decline in development expenditures had reflected the completion of major projects, as well as the postponement of some projects with low priority. He had been pleased to note that the authorities would follow the same prudent fiscal stance in 1984.

He also commended the authorities on the substantial progress made in streamlining and strengthening the financial system, Mr. Suraisry continued. After the banking crisis of the late 1970s, the Currency Board had been converted into a central bank with enhanced supervisory powers. Since then, the regulation of banks had been steadily improved. As a result, the financial position of commercial banks had strengthened significantly in recent years. Furthermore, the annual rate of monetary expansion, having gradually been brought under control, had been in continuous decline since 1980.

The exchange rate policy was appropriate, Mr. Suraisry agreed with the staff. He commended the authorities for maintaining an exchange and trade system that was free of restrictions. He also commended them for their generous aid, which still amounted to about 5 percent of GDP.

As to structural adjustment, considerable progress had been made in recent years in diversifying the productive base of the economy, Mr. Suraisry observed. The diversification efforts would be aided by the closer cooperation being fostered among the members of the Gulf Cooperation Council. The elimination in March 1983 of barriers to the movement of goods and of factors of production among members of the GCC would help to enlarge their markets, thereby promoting diversification.

Welcome technical assistance was being extended by the Fund to the United Arab Emirates, Mr. Suraisry noted. The importance that the authorities attached to regular consultations with the Fund, as evidenced by their wish to be on the standard 12-month cycle, was also welcome.

Mr. Salehkhou said that economic performance in the United Arab Emirates in 1983 had continued to be deeply affected by conditions in the world oil market, reflecting the dominance of the oil sector over economic activities and the fiscal and external position. Though the broad deteriorating trend had started in 1981-82 and continued in 1983-84, its effects had been largely contained. In contrast with many oil exporting countries, the United Arab Emirates' relatively small population and the surpluses that it had accumulated earlier had enabled it to cushion the impact of present difficulties. The authorities' reaction to those difficulties, particularly the newly restrained fiscal stance, had also helped to bring about some degree of adjustment. Thus, the decline in oil revenues had led to a reassessment of overall economic policies, as the authorities attempted to adjust the economy to a lower level of income.

The fiscal adjustment had been particularly strong, Mr. Salehkhou observed. The authorities had reacted appropriately to the continued decline of oil revenue, which in 1983 had fallen to a level 42 percent below that of 1981, by significantly reducing public sector expenditures. The burden of that adjustment had fallen mainly on development outlays, although there had also been some reduction in current budget expenditures. Particularly welcome in that respect had been the sharp decline in federal subsidies and transfers since 1981, including the near-elimination of subsidies on petroleum products. The reduced spending also reflected the authorities' decisions to slow down somewhat the pace of ongoing projects, and the initiation of new ones, as well as substantial cuts in foreign loans and grants. It should be noted, however, that the Emirates' foreign assistance remained high as a proportion of GDP and by international standards, despite the deep cuts made in 1982 and 1983.

As a result of spending cuts, and reflecting the dominant weight of public sector expenditures in the economy, Mr. Salehkhou went on, the deteriorating trend of real economic growth had been confirmed by the marked slowdown in economic activity. Real non-oil output had declined by 2 percent in 1983, compared with increases of 13 percent in 1981 and of 6-7 percent in 1982. The containment of development expenditures was clearly affecting the authorities' long-term objectives, aimed at a wide diversification of the productive base of the economy away from the oil sector. Such diversification remained crucial if the Emirates were to achieve more balanced and sustainable economic growth.

Lower development expenditures and world oil market conditions had, however, only marginally affected oil and gas exploration and field development plans, Mr. Salehkhou noted. Although that marginal effect was hardly consistent with the desired diversification of the economy, such expenditures should increase the flexibility of the Emirates' oil output policy and improve the productivity of many existing oil fields.

As for monetary developments, Mr. Salehkhou added, the financing of the 1983 budget through a drawdown of government deposits with the banking system had led to a sharp deceleration in domestic liquidity expansion and to a significant abatement of inflationary pressures. A number of reforms undertaken in 1983 should also enhance the ability of the central bank to finance the banking system. In the staff's presentation of monetary developments, he had been most interested in the information dealing with Islamic banking in the United Arab Emirates. While he understood that community-oriented banking was still at an early stage, and that so-called commercial banking remained to a large extent the rule, he believed that Islamic banking deserved to be treated in more detail in the report on recent economic developments, especially as its importance in the banking system was assumed to be growing and as various other members of the Fund were also attempting similar experiments.

Finally, Mr. Salehkhou observed, despite the steep decline in export earnings from oil and gas, the current account of the balance of payments had continued to show a substantial surplus. The overall balance had, however, recorded a small deficit for the first time in a decade. While external performance in 1983 had clearly been below that of previous years, it remained largely satisfactory and should not be of any particular concern.

Mr. Hassan remarked that he was in broad agreement with the staff appraisal of the recent peformance of the U.A.E. economy. Overall economic activity in the past two years had been adversely affected by the sluggish demand for oil, reflecting the country's high dependence on the oil sector. The sharp drop in oil and gas production had led to declines in GDP of about 5 percent in 1982 and of a further 14 percent in 1983. Nonetheless, two positive elements should be noted: inflationary pressures had been eliminated, and the current account remained in surplus.

The current situation in the United Arab Emirates clearly underscored the need to diversify the economy away from overdependence on oil, Mr. Hassan commented, thereby reducing its vulnerability to exogenous shocks in the oil market. In that respect, he welcomed the recent emphasis on developing the agricultural and manufacturing sectors.

The U.A.E. authorities were to be commended for their prudent approach to fiscal policy in the wake of the sharp decline in oil revenues, Mr. Hassan continued. In that respect, he had noted the reduction in petroleum product subsidies and the restrained wage policies that had been put in place. However, in an economy such as that of the United Arab Emirates, where economic activity was closely linked to the level of government spending, sharp cutbacks in public expenditure could be costly in terms of economic growth. That suggested a need to broaden the revenue base, but for all practical purposes, it had to be realized that progress in that respect would hinge on the extent to which the authorities succeeded with their policy of diversification.

The recent improvement in the structure of the assets and liabilities of the commerical banks should enhance their ability to handle possible adverse developments resulting from the slackening in economic activity, Mr. Hassan considered. Meanwhile, priority should be given, in the context of the Government's diversification program, to ensuring adequate control and supervision by the central bank over commercial banks in order to improve the quality of credit and to ensure that resources were channeled to the most productive sectors of the economy. Like Mr. Salehkhou, he had noted with interest the staff's brief remark on the development of noninterest banks in the United Arab Emirates. He urged that a deeper analysis of the functioning of those banks be made, in view of the increasing importance that they had begun to assume in many Middle Eastern countries. In future staff reports for Article IV consultations with such countries, the staff might perhaps make specific mention of developments in Islamic banking.

The shortfall in oil exports had left clear marks on the balance of payments, Mr. Hassan remarked. After a decade of surpluses, the overall balance of payments had recorded a small deficit in 1983. However, the current account remained in surplus, and the United Arab Emirates continued to enjoy a comfortable reserve position, with no significant external debt. Nevertheless, he encouraged the authorities to be cautious and to monitor the external position closely to avoid the possibility of its deterioration.

He had taken note of the U.A.E. authorities' desire for more frequent Article IV consultations in future, Mr. Hassan said, and he therefore supported the recommendation that Article IV consultations with the United Arab Emirates be held on a standard 12-month cycle. Finally, the United Arab Emirates deserved to be commended for the sizable development assistance that it had continued to provide, despite its present difficult circumstances.

Ms. Bush said that her authorities were quite favorably impressed with the prudent way in which the United Arab Emirates had responded to the widespread impact on the economy of declining oil production, exports, and fiscal revenues. The staff had highlighted the critical role being played by fiscal policy and offered what appeared to be good advice in several areas. For example, the authorities would indeed be wise not to contemplate expansionary fiscal policies in face of the uncertain outlook for oil revenues and to diversify the revenue base over the medium term; an immediate re-evaluation of expenditure priorities would also be appropriate. In fact, the authorities had already taken a number of measures consistent with that approach, notably, their recent overall efforts to align expenditures with the reduced level of current revenue, the near-elimination of petroleum product subsidies, and a slowdown in the initiation of new development projects.

Without knowing more about the potential for the long-term development of non-oil sectors in the U.A.E. economy, Ms. Bush commented, it was difficult to judge the relative priorities that should be assigned to the oil and non-oil sectors. However, it seemed logical for the authorities to follow the present policy of continuing to explore for oil and gas on a significant scale, with the objective of increasing the known potential for future oil development and enhancing the country's ability to respond flexibly to future changes in the world demand for oil.

A responsible fiscal policy and a complementary sharp deceleration in the expansion of domestic liquidity had made an important contribution to the virtual elimination of inflation in 1983, Ms. Bush remarked, following moderately high rates of inflation in the immediately preceding years and much higher rates in the mid-1970s. Whatever direction development policy took, price stability would be an important positive factor. In addition, she supported the efforts of the monetary authorities to improve bank supervision and to foster the evolution of financial institutions in conformity with the economic and social needs of the United Arab Emirates.

As for the external sector, Ms. Bush said, continued current account surpluses and a sound foreign reserve position provided a considerable margin for safety.

Finally, Ms. Bush noted, the United Arab Emirates appeared to be at something of a crossroads in its economic development. That underscored the importance of understanding the functioning of the economy and of improving statistical data in such areas as the national account, the energy sector, foreign debt, and total foreign asset holdings.

The staff representative from the Middle Eastern Department remarked that Islamic banking in the United Arab Emirates was still limited. Out of a total of 51 commercial banks with many branches, only one bank, operating in Dubai, had so far decided to operate along Islamic lines. The U.A.E. authorities had made a point of mentioning the satisfactory growth of that one bank's operations during the past year and of the importance that they themselves attached to means of expanding such banking activities within the United Arab Emirates in the future. The experience of the United Arab Emirates with Islamic banking practices did not therefore provide enough material for an in-depth analysis of some of the issues involved. However, he recalled that the March 1982 issue of Staff Papers had included a study on the principles of Islamic banking that had contained an evaluation of experience in Pakistan and one or two other countries.

The development of the U.A.E. economy was at a crossroads at the present time, as Ms. Bush had remarked, the staff representative added. Yet the authorities were of the view that further development of the oil and gas sector would have to take first priority in the foreseeable future, while efforts were made to develop non-oil sector enterprises both within the United Arab Emirates and in cooperation with other member countries of the Gulf Cooperation Council. Under the existing institutional arrangements in the United Arab Emirates, the principal decisions in that respect were the responsibility of the individual Emirates, and the planning process at the federal level was at an early stage of development.

Mr. Finaish said that the U.A.E. authorities were aware of the need for further improvement of both the quality and coverage of data. As in many other developing countries, the process would take time and required skills that were in short supply. Nevertheless, there had been some recent improvement.

The cuts in spending on development and economic diversification had not been that sharp, Mr. Finaish remarked. First, most of the large construction projects had been completed. Second, greater care was being exercised in selecting new projects. As the staff had stated in its appraisal, considering that "budget expenditures were on a rapidly rising trend prior to 1982, the recent reversal thereof would seem to have provided a welcome occasion for re-evaluating expenditure priorities and improving the efficiency of resource allocation." The United Arab Emirates' history of fast development suggested that there was indeed room for improving the allocation and efficiency of investment.

Reference had been made by Executive Directors to the generous development aid granted by the United Arab Emirates, Mr. Finaish recalled. Moreover, while commending the authorities on their generous aid policy, the staff in its appraisal had expressed the hope that such aid would continue. That aid was high by any standards, being at present at close to 5 percent of GDP; in fact, it had increased in 1983 to about 15 percent of net oil revenues. Furthermore, the aid was not tied, and its source was income from a depletable asset. Unlike aid from major countries, the United Arab Emirates' foreign assistance was not induced by global interests. The U.A.E. authorities would be interested in knowing whether the staff also expressed the hope, in its appraisals in staff reports for consultations with major industrial countries, that the level of their aid would increase. Aid was less than 1 percent of the GNP of most rich countries, which were moreover not dependent on a depletable asset. However, the intention of the U.A.E. authorities was to maintain their development aid, which of course was derived not only from oil income but from the remittances of expatriates, who accounted for 75 percent of the population, and from private investment flows.

Finally, Mr. Finaish remarked, as the staff representative had stated, with the exception of one Islamic bank in one of the Emirates, all U.A.E. banks were run on a commercial basis. As he understood the wish of the authorities, it was that the staff should take into account the growing interest in Islamic countries in general in the phenomenon of noninterest banking, not only in the context of a single country.

The Acting Chairman made the following summing up:

> Executive Directors generally agreed with the views expressed in the staff appraisal contained in the report for the 1984 Article IV consultation with the United Arab Emirates.
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> Directors complimented the authorities for the skill with which they had responded to declining oil revenues. They noted that there had been a pronounced slowdown in domestic economic activity in the United Arab Emirates since the second half of 1982, brought about by the more restrictive stance on budget expenditures adopted by the authorities in response to the sharp decline in oil and gas export revenues after 1981. In the circumstances, Directors were of the view that this policy

response had been appropriate and that the reduction in expenditure had been gradual and thus not disruptive. In particular, the authorities had been successful in controlling wages and salaries and in reducing federal subsidies and transfers.

Looking to the future, Directors stressed the importance of diversification of the economy as well as the more intensive development of available oil and gas resources in this connection. They encouraged the authorities to improve the collection and reporting of economic data for the purpose of economic policy formulation.

Directors took special note of the progress made in recent years in the area of central bank supervision and regulation of commercial bank operations. Recent developments highlighted the continuing importance of adequate commercial bank capitalization and of other appropriate supervisory guidelines for bank credit operations.

Directors observed that the external payments position of the United Arab Emirates had remained strong despite the recent decline in oil and gas export earnings. They commended the U.A.E. authorities for their continued pursuit of generous foreign aid policies. Directors also commended the authorities for maintaining an exchange and trade system free of restrictions.

Finally, Directors agreed that the next Article IV consultation with the United Arab Emirates would be held on the standard 12-month cycle.

3. JAMAICA - STAND-BY ARRANGEMENT - EFFECTIVE DATE

The Executive Directors considered a staff paper on a request by Jamaica for an extension of the date by which the stand-by arrangement for Jamaica should become effective, from June 20, 1984 to June 27, 1984 (EBS/84/101, Sup. 4, 6/20/84).

Mr. Shaw recommended that the extension be approved.

Mr. Polak remarked that he had no objections to the extension, although he had been surprised by the specific reference in the proposed decision to the arrangement's becoming effective when "a satisfactory structure of telephone rates has been announced." Surely, a more general reference could be made to whatever measures remained to be taken, if indeed any reference were needed at all, because according to Supplement 4, the new structure of telephone rates had in fact been approved.

The Deputy Director of the Exchange and Trade Relations Department explained that the new structure of telephone rates had been agreed upon as a prior action. Cabinet approval of the increases in telephone rates had been withdrawn; if the new charges were not put into effect as had been agreed, the Jamaican authorities and the staff would have to agree on other measures that would have a similar fiscal impact, and a further recommendation would have to be made to the Executive Board. The issue at stake was that a prior action had not been taken as had been expected and understood.

Mr. Ismael considered that the proposed extension of the date by which the stand-by arrangement should come into effect seemed appropriate. Would it also be necessary to extend the period within which Jamaica's drawing under the compensatory financing facility, which had been approved at the same time as the stand-by arrangement, could be made?

The Deputy Director of the Exchange and Trade Relations Department responded that the Executive Board decision approving Jamaica's request for a purchase under the decision on compensatory financing of export fluctuations had provided that the purchase should be made as of the date on which the stand-by arrangement became effective. The staff's recommendation and the Executive Board's decision had recognized the policy that a compensatory financing purchase in the upper tranche, while not dependent upon the member's having a program in place, was dependent on policies' being in place that would offer an assurance of adequate adjustment. When the Executive Board had agreed in principle to the stand-by arrangement for Jamaica, it had not been possible to state that all of the necessary adjustment measures had been taken, in the absence of satisfactory arrangements for the refinancing of certain short-term liabilities.

Mr. Suraisry supported the proposed decision.

Mr. Zhang asked what significance the increase in telephone rates would have for the whole adjustment process, and whether it would have much impact on the balance of payments. In addition, it would be most unwise to single out a measure of prior action in a proposed decision.

The staff representative from the Western Hemisphere Department replied that the significance of the telephone rate adjustment, in terms of the program, was not negligible. The combined loss of revenue of the international and domestic telephone companies, if the measures were not implemented, would be approximately J$50 million, equal to about 0.6 percent of GDP. Furthermore, certain limits had been set in the program on the amount of total financing to the public sector. Many different measures had been necessary to reach those limits, including adjustments in domestic sugar prices, cutbacks in investments in certain projects, and of course the adjustment in telephone tariffs. In submitting Jamaica's request for a stand-by arrangement to the Executive Board, the staff had given an assurance that the series of measures had been put in place, based on an assurance to that effect from the Jamaican authorities. Had that prior action not been taken or had it been amended, the design of the program would have been changed, and a financing gap would have existed.

The Deputy Director of the Exchange and Trade Relations Department recalled that the prior actions had been spelled out in detail in Part III of Supplement 1 to EBS/84/101. The staff had at that time reported on its understanding that those prior actions had been implemented. Although it would be possible for the Jamaican authorities to decide on substitute measures for the increase in telephone rates, which the staff could assess and present to the Executive Board, it should be noted that the authorities had already examined many options in their efforts to find measures to generate revenue; it might take them some time to find a feasible alternative measure to the restructuring of telephone rates.

Mr. Zhang stated that, in principle, he was against mentioning specific measures in such a decision. If it was too late to amend the decision bringing Jamaica's stand-by arrangement into effect, its approval should not be taken as a precedent but as a very exceptional case.

The Deputy Director of the Exchange and Trade Relations Department noted that normally the staff would not bring an arrangement to the Executive Board before all the prior actions in the program had been taken. In the present case, the staff could have been accused of a lack of disclosure if it had not brought to the attention of the Executive Board the fact that a prior action, which it said had been implemented, was not in truth in place.

Mr. Salehkhou joined Mr. Polak and Mr. Zhang in considering that the issue was not significant enough to warrant its becoming a condition for approval of the stand-by arrangement. Reliance should be placed on the good faith of the authorities to work out a solution.

The Acting Chairman remarked that the prior actions described in Supplement 1 to EBS/84/101 had in fact been listed in an attachment to a letter from the Governor of the Bank of Jamaica, mentioning that he was attaching a report on the current status of the measures to be acted upon prior to Board approval. He understood that there had been previous cases in which specific actions had been mentioned in the decision approving a stand-by arrangement in principle.

The Deputy Director of the Exchange and Trade Relations Department considered that there was a difference between a decision in which the Executive Board approved a stand-by arrangement in principle, pending the implementation of a prior action, and an arrangement that had in fact already been approved in principle, subject only to arrangements for satisfactory financing, but where it had subsequently been learned that one of the prior actions in the program that had been approved had been withdrawn.

Mr. Govindarajan said that he concurred with the views expressed by Mr. Salehkhou and Mr. Zhang. There was no dispute about the increase in telephone rates, which had already been agreed. The problem could be resolved if more general language could be found to ensure that the measure was in fact carried out.

Mr. Polak proposed that paragraph 3(b) of the proposed decision should refer, in general terms, to the Jamaican authorities' having put in place all the prior actions described in Supplement 1 to EBS/84/101.

Mr. Clark suggested that paragraph 3(b) of the proposed decision should read: "until it is confirmed that all actions and understandings specified in the attachment to the letter of the Governor of the Central Bank of Jamaica have been implemented."

The Deputy Director of the Exchange and Trade Relations Department said that it would be advisable to avoid referring in the decision to the precise stage of implementation of the several prior actions specified in the attachment to the letter from the Governor of the Bank of Jamaica.

Mr. Clark remarked that his suggested language could be amended to refer to the full compliance of the authorities with the terms of the stand-by arrangement.

Mr. Shaw confirmed that it was the announcement of the increases in telephone rates, and not the actual increases themselves, that had not been made. The increase in the telephone rates was scheduled to take effect on July 1, 1984. He would prefer a decision that refrained from mentioning a specific measure, although his Jamaican authorities had been willing to accept the staff's view that, because the increases had not yet been made public, the conditions on which the stand-by arrangement had been approved had not been fully met.

The Acting Chairman suggested that the language proposed by Mr. Clark would seem to meet the wishes of the Government of Jamaica while at the same time responding to the desire of several Executive Directors not to refer to specific prior actions in the proposed decision.

The Executive Board then approved the proposed decision, as amended.

The decision was:

1. The Government of Jamaica has requested a stand-by arrangement for a period of one year for an amount equivalent to SDR 64 million.

2. The Fund approves the stand-by arrangement set forth in EBS/84/101, Supplement 3, subject to 3 below, and waives the limitation in Article V, Section 3(b)(iii).

3. The stand-by arrangement set forth in EBS/84/101, Supplement 3, Revision 1, shall become effective on the date, but not later than June 27, 1984, on which the Fund finds that satisfactory arrangements have been made for the refinancing of certain short-term liabilities and that it is confirmed that the

authorities have complied fully with the terms and understandings contained in the attachment to the letter of the Governor of the Central Bank of Jamaica dated May 31, 1984, reproduced in Supplement 1 of EBS/84/101.

Decision No. 7738-(84/97), adopted
June 20, 1984

APPROVED: February 1, 1985

LEO VAN HOUTVEN
Secretary