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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/100

10:00 a.m., June 27, 1984

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
	H. G. Schneider
	X. Blandin
	G. E. L. Nguyen, Temporary
A. Donoso	
	M. K. Bush
	S. R. Abiad, Temporary
T. Hirao	T. Yamashita
	Jaafar A.
	I. R. Panday, Temporary
	D. I. S. Shaw, Temporary
	H. A. Arias, Temporary
	G. Grosche
	N. Coumbis
R. N. Malhotra	
	S. El-Khouri, Temporary
	T. de Vries
A. R. G. Prowse	
G. Salehkhou	
	E. I. M. Mtei
M. A. Senior	
	K. A. Hansen, Temporary
	T. A. Clark
	J. Bulloch, Temporary
	D. J. Robinson, Temporary
Zhang Z.	Wang E.

J. W. Lang, Jr., Acting Secretary
C. Fairbairn, Assistant

Also Present:
B. Legarda, Consultant. African Department: R. J. Bhatia, Deputy Director; O. B. Makalou, Deputy Director; E. A. Calamitsis, C. N. Egwim, M. G. Gilman, S. Schiavo-Campo, R. T. Stillson, J. C. Williams. Asian Department: P. R. Narvekar, Deputy Director; H. Neiss, Deputy Director; D. A. Citrin, J. H. Felman, S. Kasaju, D. C. L. Nellor, I. Otani, S. Shah, X. Vongsathorn, R. C. Williams. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; M. Guitian, S. Kanesa-Thasan. Fiscal Affairs Department: G. Blöndal, A. Premchand, C. Schiller. IMF Institute: I. Shrestha, S. Shrestha, Participants. Legal Department: W. E. Holder, J. M. Ogoola, S. A. Silard. Research Department: W. C. Hood, Economic Counsellor and Director; K.-Y. Chu, W. Huyser, N. M. Kaibni, T. K. Morrison. Secretary's Department: A. P. Bhagwat. Bureau of Statistics: L. D. Dicks-Mireaux. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, H.-S. Lee. Assistants to Executive Directors: H. Alaoui-Abdallaoui, R. L. Bernardo, M. Camara, M. B. Chatah, M. Eran, G. Ercel, C. Flamant, V. Govindarajan, D. Hammann, N. U. Haque, A. K. Juusela, H. Kobayashi, E. Landis, M. Lundsager, T. Ramtoolah, M. Rasyid, J. Reddy, A. A. Scholten, S. Sornyanyontr, A. Yasseri.

1. REPORT BY MANAGING DIRECTOR

The Managing Director said that he had recently visited Canada where he had given an address on international debt problems at the Annual Conference of the Investment Dealers Association of Canada. He had also engaged in useful talks in Ottawa. On June 4, Mr. Lalonde, the Canadian Minister of Finance, had organized a dinner, followed by a question and answer session with officials, bankers, and businessmen on the work of the Fund, the debt problem, and the world situation. As always in Canada, the discussion had been lively and frank, and he requested Mr. Shaw to thank the Canadian authorities for their hospitality.

2. MADAGASCAR - PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered the staff paper on a request from Madagascar for a purchase of SDR 14.4 million under the compensatory financing facility (EBS/84/120, 5/30/84; and Sup. 1, 6/25/84).

The staff representative from the Research Department noted that the text of footnote 1 on page 9 of EBS/84/120 had inadvertently been placed on page 12; the second reference to footnote 1 should read "footnote 2," and the reference to footnote 2 should read "footnote 3."

Mr. Tshishimbi made the following statement:

> Madagascar is critically dependent on very few export commodities, of which cloves are the second most important, representing 24 percent of total export earnings in 1982. It is largely on account of a shortfall in earnings from clove exports that Madagascar is requesting a drawing under the compensatory financing facility.
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> Clove shipments to Indonesia, the world's largest producer and consumer of cloves and also the largest importer, account for nearly 70 percent of Madagascar's clove exports. As indicated in the staff paper, under a four-year sales arrangement concluded in 1981, Madagascar may export an annual shipment of 6,000 tons of cloves to Indonesia. However, in 1983 no cloves were exported because the two Governments could not reach agreement on the price. In these circumstances and given the structure of the world demand for cloves, Madagascar was unable to find new alternative markets, and its clove exports were limited to its annual shipments to other traditional markets. The fall in clove exports in 1983 was thus clearly due to factors beyond the control of the Malagasy authorities.
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> In 1983, the current account of the balance of payments of Madagascar improved slightly from its 1982 position, due mainly to a decline in imports. However, because of a substantial reduction in capital inflows, the overall balance of payments deficit doubled to SDR 253 million. Clearly, there was a balance of payments need in the shortfall year.

With regard to the test of cooperation, Madagascar has been implementing an economic and financial program with the Fund's financial support. In a few weeks, when the Board has an opportunity to review the program, it will know that Madagascar has achieved significant progress and has met all the performance criteria under the program.

In my opinion, the request for a drawing under the compensatory financing facility meets all the conditions required and deserves the Board's support.

Mr. Salehkhou said that he was in broad agreement with the staff appraisal of Madagascar's request for a new drawing under the compensatory financing facility; he supported the proposed decision. It was clear from the staff paper that Madagascar's request largely met all the requirements for a compensatory financing drawing in the upper tranche, although the emphasis on the noncompetitive character of the world clove market might have given the wrong impression that Madagascar's situation had been highly unusual. In its analysis of the causes of the shortfall in export earnings, which had been due entirely to the sharp reduction in the volume of clove exports following unsuccessful trade negotiations between Madagascar and Indonesia in 1983, the staff appropriately concluded that the shortfall had been largely beyond the control of the Malagasy authorities, without putting the blame for the cessation of clove exports on either of the two parties.

The staff had used actual data in their calculation of the shortfall, Mr. Salehkhou continued, so that the requested drawing would fully compensate, but not overcompensate, for the shortfall in 1983. The staff's estimate of earnings from clove and other exports for the two postshortfall years was conservative, despite the large increase in earnings predicted for 1984, which was based largely on signed contracts and on performance in the first quarter of 1984; the estimates for 1985 seemed to assume a very sharp decline in clove exports.

That Madagascar had met the requirements of balance of payments need and cooperation with the Fund had also been well established in the staff paper, Mr. Salehkhou said. The staff paper on the implementation of the current stand-by arrangement with Madagascar (EBS/84/133, 6/19/84), issued only one week previously, indicated that all the policy measures of the adjustment program had been implemented.

He supported the proposed decision, Mr. Salehkhou said. However, he requested comments from the staff on the reasons for the scheduling of separate Board meetings for the request for a compensatory financing purchase and the stand-by review. The staff had undoubtedly had good reason for delaying the circulation of the review paper, but it would have been preferable to discuss the two papers at the same session by waiving the four-week rule. A waiver had been granted in other cases, and could have been extended to the review with Madagascar, particularly since it showed that performance had been mainly satisfactory.

Mr. Prowse said that it was clear that Madagascar had fully satisfied the criteria of balance of payments need and cooperation with the Fund. However, some questions remained concerning the calculation and avoidability of the export shortfall.

Concerning the technical issue of the calculation of the shortfall, Mr. Prowse said that the two preshortfall years might have been misleading in determining the trend in clove exports, which had increased by about 80 percent a year in those years, indicating that a period of temporary boom might have followed an earlier period of recession. If exports had indeed been unusually buoyant in the two preshortfall years, the long-term trend based upon them might have been overstated, particularly since Indonesia had had substantial stocks of cloves in 1984, implying purchases above trend in the two preshortfall years. The accumulation of stocks by the Indonesian authorities had perhaps created the false impression of a strong market for cloves.

The responsibility of the Malagasy authorities themselves for the shortfall should also be considered, Mr. Prowse continued. There were two sides to every negotiation, and it was particularly difficult to understand how, in a market in which there was a dominant purchaser and a dominant supplier, there had been a failure to reach a contract. He requested further comment from the Indonesian chair or from Mr. Tshishimbi on the nature of the negotiation. The staff paper suggested that Indonesia, currently the prime purchaser of Madagascar's cloves, would become a net exporter of cloves in the coming years. Since the Malagasy clove was superior in quality to the Indonesian product, Indonesia would probably continue to import cloves from Madagascar in the short term. However, it was important to give preliminary consideration to the longer-term prospects for the clove industry in Madagascar, given the potential for development of Indonesia's capacity. He wondered whether the Malagasy authorities were giving thought to the medium-term prospects for their clove industry.

Mr. Blandin said that he wished to refer first to the outcome of the Aid Donors' meeting on Madagascar that had taken place on April 5 and 6, 1984. At the conclusion of its meeting on December 21, 1983 (EBM/83/179), when the Board had refused to re-establish the amount of the current stand-by arrangement for Madagascar to an amount commensurate with its previous arrangement of SDR 51 million, Mr. de Maulde had said that "he hoped that those Executive Directors who had been unwilling to allow the Fund to make available larger resources for Madagascar would ensure that their countries would fill the gap when they attended the meeting of donor countries and creditors for Madagascar in early 1984."

As far as official creditors and the Paris Club were concerned, Mr. Blandin continued, the amount of net debt relief had been broadly in line with the staff's assumptions underlying the balance of payments prospects, although the terms of rescheduling had been much less generous than those recently granted to Sudan. However, the French authorities did not share the staff view in its report on the arrangement for financing the 1984 balance of payments deficit (EBS/84/82, 4/6/84), that satisfactory arrangements had been reached at the Aid Donors' meeting. On the contrary, the French authorities had found the outcome of that meeting unsatisfactory, because several countries that had refused in December 1983 to increase the amount of Madagascar's stand-by arrangement above SDR 33 million, had made insufficient pledges. If Madagascar's balance of payments gap had been filled, it was only because it had been reduced in the meantime; at the end of 1983, the assumption had been that balance of payments assistance for 1984 would be approximately the same as for 1983, or about SDR 55 million. Nonetheless, firm pledges at the Aid Donors' meeting had been well below SDR 55 million; even including "positive indications" of assistance, and a partial rollover of short-term debt, pledged amounts had not exceeded SDR 48 million, over SDR 7 million below the initial target. Moreover, according to the recently issued staff report on the first review of the stand-by arrangement (EBS/84/133, 6/19/84, page 7), that inadequate amount had been further reduced to SDR 42 million. Whether that sum consisted of firm pledges, or whether it too included some "positive indications," was unclear. It should also be noted that France, which had not been opposed to re-establishing the stand-by arrangement in a larger amount, had pledged almost 60 percent of the total.

The French authorities had drawn the conclusion from the outcome of the Aid Donors' meeting that the Fund had failed to fulfill its role as a catalyst, Mr. Blandin continued, since it had not elicited support that would compensate for the reduction of Fund financing. Consequently, a proper balance had not been struck between financing and adjustment in Madagascar. Furthermore, the adjustment effort that had been envisaged when the Executive Board had reached its decision in December 1983 was not the one being implemented: the financing gap had been closed through a reduction of imports from SDR 371 million, as shown in Table 7 of the staff paper on the request for a stand-by arrangement (EBS/83/255, 11/30/83), to SDR 340 million--as shown in Table 3 of EBS/84/133.

The adjustment process had therefore become more stringent, with three adverse consequences, Mr. Blandin said. First, there would be a weaker supply response. The first review of the stand-by arrangement had indicated that production had begun to respond to the various policies implemented over the past few years, particularly paddy production. However, in many areas the growth of output was still hampered by lack of spare parts and raw materials due to the shortage of foreign exchange. Allowing for an additional SDR 18 million for imports under the arrangement would clearly have had a strong multiplier effect on production and exports, and would have improved the capacity of the Malagasy economy to service debt and improve the balance of payments prospects. Second, the reduction of consumer goods imports would reduce the standard of living for the poorer segments of the population; in particular, there were shortages of powdered milk for babies and of indispensable medicines, which would inevitably raise the infant mortality rate. Third, the adjustment in imports had been so extreme that there remained no room for maneuver in the face of unforeseen events, such as the recent cyclone.

The Fund's treatment of Madagascar raised the more general question of the principle of uniformity of treatment of member countries, Mr. Blandin continued. The French authorities doubted that that principle had been applied to Madagascar. An arrangement had recently been approved for Sudan in an amount equal to more than 50 percent of quota, whereas that for Madagascar had been only 39 percent of quota, on a one-year basis. He looked forward to the opportunity to discuss the issue of comparability of treatment during the first review of the stand-by arrangement; meanwhile, he had noted that the staff report for the review indicated that the Malagasy authorities were firmly committed to adjustment, and deserved the generosity that the French authorities had argued for in December 1983.

A convincing case had been made by the staff for Madagascar's request for a compensatory financing drawing of SDR 14.4 million, Mr. Blandin considered. All the requirements set forth in the compensatory financing decision had been met, and he could therefore approve the proposed decision.

Mr. Clark said that he had considered Madagascar's request for a compensatory drawing against the normal four criteria of balance of payments need, whether the shortfall was likely to be of a short-term character, whether it was largely beyond the control of the member, and whether the member had met the requirement of cooperation with the Fund. First, it was obvious that Madagascar had a balance of payments need. Second, although clove exports might be in secular decline, Table 3 of EBS/84/120 indicated that the drop in total exports in 1983 was indeed likely to be temporary. He requested information from Mr. Tshishimbi or the staff on Madagascar's response to the medium-term prospects for the clove industry.

That Madagascar had met the third requirement of the compensatory financing decision, that the shortfall should be beyond the control of the authorities, was less easy to judge, Mr. Clark continued. Why had Madagascar and Indonesia failed to reach an agreement on clove exports? If, as he understood from press reports, the Malagasy authorities had pressed for a price 50 cents per kilogram above the Indonesian offer, the shortfall might have been substantially mitigated had Madagascar been prepared to compromise on price. On the other hand, the argument in the staff paper that Indonesia had imported no cloves from any source in 1983 was telling. Negotiations on prices were always sensitive, but some clarification of the reasons for the failure of the negotiations between Indonesia and Madagascar from either the staff or Mr. Tshishimbi would be welcome.

On the fourth criterion requiring cooperation with the Fund, he would have been more comfortable in his judgment, Mr. Clark said, had more up-to-date information been available on the progress under Madagascar's stand-by arrangement. He had noted from the recently circulated staff report for the first review under the stand-by arrangement that available indications suggested that economic developments in 1984 so far had been broadly in line with the projections for the year as a whole and that the program's objectives for 1984 would be realized. However, it would have been helpful to have had at hand a more recent objective assessment of performance than that provided by the end-December 1983 performance criteria. Furthermore, it was not altogether satisfactory that the Board was required to approve the request for compensatory financing in advance of its consideration of the review. His doubts about the status of the stand-by arrangement had been reinforced by Mr. Blandin's comments concerning the financing arrangements.

Despite those reservations, Mr. Clark said that he could support the proposed decision.

Mr. Jaafar said that he could support Madagascar's request for a drawing under the compensatory financing facility. There was clear evidence of balance of payments need, and that the authorities were cooperating with the Fund in dealing with their balance of payments problems.

He also had doubts concerning the staff's conclusion that the 1983 export shortfall had been largely beyond the control of the authorities, Mr. Jaafar remarked. In particular, it was not clear that the failure of Madagascar and Indonesia to reach an agreement on the price of cloves for 1983 was sufficient evidence to satisfy the criterion. The point was important since the shortfall was based entirely on the cessation of exports to Indonesia. In Table 4 of EBS/84/120, the unit value for cloves in the base year 1983 was shown to have increased by 10 percent, while the value of total exports had declined by about 200 percent; that situation could have been avoided had Madagascar followed a more flexible pricing policy, reflecting conditions in the export market for cloves in 1983. The most important market development in recent years had been the dramatic increase in Indonesia's capacity for clove production, both in terms of output and quality, which had made it unlikely that the 1983 price could be sustained.

In the two postshortfall years, Mr. Jaafar noted with satisfaction that allowance had been made for an 18 percent reduction in unit value in 1984, leading to a 79 percent increase in export earnings. It was also reassuring that all shipments envisaged for 1984 appeared to have been covered by contracts. To ensure the achievement of the export targets projected by the staff for 1985, it would be necessary to maintain a flexible pricing policy that was sensitive to the prospect that Indonesia's imports of cloves were likely to diminish as it moved toward self-sufficiency in producing all types of clove for domestic consumption.

Mr. Grosche said that although he had some reservations concerning Madagascar's request for compensatory financing, he could nonetheless support the proposed decision. Madagascar's case was an unusual one, since the market for cloves was highly monopolistic, with Madagascar dominating the supply side of the market and Indonesia dominating the demand side. In 1983, the shortfall year, the two countries had been unable to reach a price agreement, for reasons that could not be attributed to either side. An additional consideration was that Indonesia had imported no cloves in 1983 at all, indicating that it was approaching a state of autarchy, with major implications for Madagascar's future clove exports. The staff had taken structural changes in the clove market into account by including in its calculations only exports for which contracts had been signed or shipments made. The staff had also made a sufficiently cautious evaluation of the prospects, as indicated by its expectation of a further significant decline in clove exports in 1985.

Madagascar also met all the other requirements, Mr. Grosche commented, including the test of cooperation with the Fund, as indicated by the recently released staff report on the review of the stand-by arrangement. However, like other Directors, he would have preferred to take up the request for compensatory financing and that report at the same time. He requested an explanation from the staff on the rationale for the change in timing.

Ms. Bush said that, although Madagascar appeared to have met the criteria entitling it to a drawing under the compensatory financing facility, she was still dubious as to its qualifications for such assistance. In particular, it was not clear that the export shortfall had been completely beyond the control of the Malagasy authorities, since it resulted from a failure to complete negotiations for exporting the clove crop. Given the clear expectation of a decline in demand for Madagascar's cloves and its difficult balance of payments position, she would have expected the Malagasy officials to show flexibility in the negotiations. Furthermore, the price differential--a mere 50 cents per kilogram--had been 7 percent of the buyer's price or 6 percent of the asking price. With such a narrow price differential, it was difficult to understand why no agreement had been reached.

Concerning Madagascar's cooperation with the Fund, Ms. Bush said that she had just received the staff report for the review of the stand-by arrangement that had been scheduled for consideration at the same time as the request for compensatory financing. While the cyclone had undoubtedly disrupted the economy, she was concerned that the program for the remainder of 1984 was still unformulated. If the determination of the performance criteria were to be left until a review was taken in the summer of 1984, the authorities would have little time to put into effect any adjustment measures to improve the economic situation in Madagascar; the pessimistic medium-term projections contained in the original request for a stand-by arrangement indicated that Madagascar could not afford to postpone implementation of its adjustment program. In addition, since it was unlikely that Madagascar would reduce its debt service burden in the near future, it might not be appropriate for the Fund to add to the country's future debt service payments by providing additional financing.

The staff should be particularly careful in its consideration of requests for compensatory financing to ascertain that a shortfall had genuinely been beyond the control of the member, Ms. Bush remarked. Also, as other Directors had pointed out, a special feature of Madagascar's request was that it involved both the major exporter and the major importer of the commodity in question. Finally, she asked the staff for a more detailed explanation of why the export shortfall had been beyond the control of the authorities.

Mr. Malhotra said that he agreed with the staff that the tests of balance of payments need and cooperation with the Fund had been fully met by the Malagasy authorities. On balance, the staff had been right to conclude that the failure of the price negotiations had been beyond the control of the Malagasy authorities. However, if Indonesia were indeed fast approaching self-sufficiency in clove production, Madagascar would need to review the prospects for the crop, its pricing policy, and the likely market conditions for cloves in future. He supported the proposed decision.

His chair had shared other Directors' apprehensions when the stand-by arrangement for Madagascar had been discussed in December 1983, Mr. Malhotra recalled. The financing proposed at that time had been inadequate. He had hoped that sufficient aid would have been forthcoming as a result of the consultative group meeting to cover the estimated financial gap. It now appeared, from the detailed statement made by Mr. Blandin, that a financial gap remained that had been met only by a further compression of imports. If that were indeed the case, the Fund should take it as guidance in future and provide adequate financing.

Mr. de Vries said that the nature of Madagascar's export shortfall was unusual; it could be fitted into the concept of compensatory financing only with great difficulty. There was one dominant purchaser and one dominant supplier in the clove market. The purchaser bought cloves only when it had depleted its stocks, so that in one year its imports might increase rapidly, and in the following year, it might neither negotiate nor import. The inevitable outcome was an export shortfall for the supplying country in single years that was clearly not a shortfall in the usual sense of the word. An additional and undesirable complication would arise if one of the two negotiators were to use its access to the compensatory financing facility as a bargaining weapon.

There was a danger that the formula used for calculating an export shortfall could magically produce one, Mr. de Vries said. The statistics on clove exports indicated a very rapid expansion in 1981 and 1982, a large drop in 1983, a small rise in 1984, and another fall in 1985. From the figures, and according to the usual formula, the staff had been able to compute an export shortfall, a result that in the long run would be of no benefit to the compensatory financing facility. It was, after all, an unconditional facility, apart from the criterion of cooperation with the Fund. The existence of a genuine shortfall was therefore highly important and essential if the credibility of the compensatory financing facility was not to be diminished.

The Malagasy authorities could be inflexible negotiators, Mr. de Vries remarked, a trait which had clearly worked against them. They had priced themselves out of the clove market in 1983, and might have done so for the medium and even the long run also.

Inflexibility was also evident in the authorities' implementation of the adjustment measures, Mr. de Vries continued. They had undoubtedly taken stringent measures, but the economic situation remained far from satisfactory. It appeared that the authorities were clinging to preconceived notions with great tenacity in the face of a reality that would point in a different direction, an attitude that did not bode well for progress in the medium term.

Nonetheless, he was prepared to give Madagascar the benefit of the doubt, Mr. de Vries said. It was not possible to determine who had been to blame for the breakdown in the bilateral negotiations. However, more care should be taken in preparation of requests for compensatory financing in order to protect the facility, which might otherwise suffer the same fate as Madagascar and lose its market.

Mr. Mtei said that he could support the proposed decision. Madagascar's balance of payments need, evidenced by the low levels of reserves and large current account and overall deficits, had been clearly demonstrated, as could be seen from Table 1 of the staff paper. The shortfall of SDR 14.4 million in export earnings, which had been calculated using actual data, had been caused by factors outside the control of the authorities. As indicated by the staff, the 1983 shortfall had resulted largely from a decline in the volume of clove exports to Indonesia following a breakdown in negotiations on an export price acceptable to both parties. Given the nature of the export market for cloves, the outcome had not been unusual. Tanzania, another major exporter of cloves, had also exported no cloves to Indonesia in 1983. He therefore agreed with the staff that the authorities of both countries had negotiated in good faith and that the breakdown of the discussions could not be attributed to either party.

It was encouraging to note that an acceptable price had since been agreed upon, Mr. Mtei continued, and that it had formed the basis for the projected recovery in export earnings in the postshortfall year, indicating that the 1983 shortfall had indeed been temporary.

Madagascar had met the test of cooperation in its implementation of the program under the current stand-by arrangement, Mr. Mtei stated. Like other Executive Directors, he would have preferred to discuss the review paper at the same time as the request for a compensatory financing drawing. He shared Mr. Blandin's views on the way in which the arrangement had been approved and on the outcome. A preliminary examination of the review paper indicated that the authorities had been successfully carrying out the program so far, despite difficulties which had been compounded by a severe cyclone that had caused extensive damage in the northern part of Madagascar. Their success so far was a clear indication of the authorities' determination to cooperate with the Fund in finding solutions to Madagascar's balance of payments problems.

Mr. Shaw said that he supported the request of the Malagasy authorities for a purchase under the compensatory financing facility. It was clear from the staff paper that there had been a significant shift in short-term demand for cloves. The demand function for cloves might, he suspected, have been an infinite slope in 1983, so that there would have been no exports to Indonesia at any price.

Mr. El-Khouri said that he also supported Madagascar's request.

A Deputy Director of the African Department explained that the staff had been aware that, given the timing of the review mission, it would not have been possible to issue the report with the customary four-week interval preceding the discussion of the request for compensatory financing scheduled for the end of June. Therefore, the staff issued the report within four days after the mission returned from Madagascar on June 14, expecting that the Executive Board would ask to have the four-week rule waived. In the absence of such a request, the report for the review had been scheduled for discussion with the usual four-week notice.

The postponement of the review discussion should not be taken as an indication that the implementation of Madagascar's stabilization program had also been postponed, the Deputy Director stated. As Ms. Bush had noted, Madagascar could not afford to postpone implementation of the program. Although as yet there were no technical performance criteria relating to credit expansion in the economy for end-September and end-December 1984, the program was currently following the course intended from the outset. Indeed, in the first quarter of 1984 the government budget had been in surplus, although the significance of the surplus should not be exaggerated, owing to seasonal effects. Also, at the very outset of the program, some of the criteria, such as external debt ceilings, had been set for the whole of 1984. It was preferable not to set the other criteria beyond June 1984 until an assessment of the cyclone damage had been made, which was not possible at the present time. Meanwhile, the authorities were continuing to implement the program as originally intended.

In submitting its judgment to the Executive Board that satisfactory arrangements had been made to finance Madagascar's balance of payments deficit, the staff had been using a purely technical criterion, namely, that a certain balance of payments gap had been indicated in the stand-by arrangement, the Deputy Director noted. The staff had wished to certify that sufficient financing had been promised so that that particular gap could be filled, and that there would be no unfinanced gap or increase in arrears. The staff had felt that, on the basis of the outcome of both the Paris Club and the aid meetings, as well as the draft agreement with the commercial banks on debt rescheduling, the gap of SDR 164 million had been covered. It had not been for the staff to judge whether the donors or the Paris Club had been generous enough. He did not agree with Mr. Blandin that the balance of payments gap had been financed by deflationary measures additional to those assumed when the program was considered by the Board. Certainly, the means by which the gap had been financed had not been made explicit by the staff, and it was true that current import estimates were lower than those initially assumed. However, the contraction of imports had not been a result of decisions made at the aid conference or at the Paris Club meeting, but rather was the result of adjustment measures taken following discussions with the authorities in February 1984 on the basis of which the Board had finally approved the stand-by arrangement (EBS/84/45, 3/8/84; EBM/84/42 and EBM/84/43, 3/19/84; EBS/84/82, 4/6/84; EBM/84/59, 4/18/84). The measures included liberalization of pricing and marketing practices and a devaluation of the exchange rate. As a result, domestic production would become more efficient and domestic goods more attractive, with a complementary reduction in imports. No reduction of imports through other mechanisms had been planned. The program maintained the original assumption that the expenditure of foreign exchange on raw materials would increase by approximately 17 percent in 1984 compared with 1983. Public investment planned for 1984 remained as indicated to the Board at the time of the February 1984 discussion on the stand-by arrangement and was considered adequate by the World Bank.

Agreement had been reached on most of the SDR 42 million in assistance that was promised to Madgascar, the Deputy Director noted. Approximately 10 percent of the sum remained in the form of positive indications, primarily due to the budgetary requirements of some of the donor countries and the diverse means by which bilateral aid was given. One country had not yet held discussions with the Malagasy authorities, so that its promise of aid was still considered to be a positive indication rather than a firm pledge.

In response to a question by the Chairman, the Deputy Director of the African Department replied that the staff had calculated a specific performance criterion relating to the reduction of arrears, which had been based on particular estimates of foreign exchange inflows and outflows. The amount of the compensatory drawing had been included in the calculations, on the assumption that the request would be discussed in the Board before the end of June; had the drawing been postponed, Madagascar might have been unable to meet the criterion. The authorities had broadly met the criterion for the end of June.

The staff representative from the Research Department recalled that Mr. Prowse had asked about the calculation of the export shortfall, and the extent to which the staff had taken into account the fact that exports of cloves in 1981-82, the two preshortfall years, had been unusually high. Such an export pattern was not unusual for primary commodities, many of which went through periods of sharp price variation. In general, earnings from individual commodities fluctuated much more sharply than the aggregate value of a country's total exports, which was, of course, the relevant basis for determining the amount of the shortfall. Thus, even though Madagascar's annual clove exports had fluctuated widely in recent years, its total exports had been characterized more by stagnation than by sharp upward or downward movements. Perhaps more emphasis had been placed on a single commodity, cloves, because of the unusual circumstances surrounding the export shortfall for that commodity in 1983. It should be noted, however, that cloves represented only about 8 percent of Madagascar's total exports in the shortfall year, and while the drop in export value had contributed to the shortfall in total earnings in 1983, the surge in clove earnings in prior years had contributed to an opposite outcome for those years.

As to whether the shortfall had been beyond the control of the Malagasy authorities, the staff representative said that the staff did not know the full details of the negotiations between Indonesia and Madagascar; the disagreement had been primarily over price, although other factors might also have been involved. Among the factors that influenced the staff's judgment that the shortfall in cloves was largely beyond the control of the authorities was the fact that no alternative markets existed in the short run to which Madagascar could export such a large quantity of cloves. Historically, Madagascar had accounted for about two thirds of world clove exports, totaling about 15,000 tons, and about two thirds, corresponding to 6,000-7,000 tons, of Madagascar's exports had traditionally gone to Indonesia. The single most important element that had influenced the staff's judgment was the fact that Indonesia had not imported cloves from any source in 1983. Madagascar had maintained its clove exports to other markets, and it had not lost market shares during 1983, because other clove exporters, such as Tanzania, had not benefited from the lack of exports by Madagascar to Indonesia. No single supplier could be held responsible for the absence of demand by Indonesia in 1983.

The staff had taken into account the changing structure of the clove market when making its projections for the two postshortfall years, the staff representative added. Madagascar's clove exports to Indonesia had been projected at about 3,000 tons in 1984 and about 1,000 tons in 1985, a substantial drop from the traditional annual levels of 6,000-7,000 tons. Those projections represented a significant change in the market for one of Madagascar's major commodity exports, but he could not comment on the authorities' response to this development.

Mr. Blandin said that he agreed with the Deputy Director of the African Department that it was difficult to assess whether the reduction in imports by Madagascar had been a direct consequence of the financial package or whether it had been a consequence of the adjustment program, which had, in turn, been a result of the financial program. The fact remained that if imports could be increased to the original level of SDR 371 million, the supply response of the economy could be larger, since SDR 31 million would be available to pay for imports of spare parts and raw materials. The point to be emphasized was that the provision of greater room for maneuver in the Malagasy economy would be highly productive.

Ms. Bush said that, in view of the additional arguments put forward that morning, and particularly as Indonesia as the dominant buyer had not imported cloves from any other source in the shortfall year, she could support the request from the Malagasy authorities.

Mr. Tshishimbi said that joint scheduling of the discussion of the request for compensatory financing and the review paper had not been possible owing to the uncertainty surrounding the circulation date of the latter paper, particularly since the mission had still been involved in discussions in Madagascar when the date for the discussion of the request for compensatory financing had been decided. It was always difficult to predict the time it would take the staff to issue its report; the review paper had been circulated on June 19, and the staff had decided to respect the general wish of the Executive Board to request a waiver of the four-week notice of a paper's discussion only in exceptional circumstances.

On the question of the negotiations between Madagascar and Indonesia, Mr. Tshishimbi mentioned that negotiations were always difficult in the case of bilateral monopolies. Both countries were well aware that Indonesia was the largest purchaser of cloves, which made it difficult to establish responsibility for a failure to reach agreement. The Malagasy authorities had maintained contact with Indonesia, and were showing flexibility on the question of price. The staff was clearly justified in concluding that the export shortfall had been beyond the control of the authorities.

The medium-term prospects for Madagascar's clove exports were difficult to predict, Mr. Tshishimbi said. Madagascar should attempt to diversify its economy in the face of changing conditions in the clove market. Although the superior quality of the African clove was still appreciated in Indonesia, it was possible that Indonesia could develop the capability to produce its own high-quality cloves, in which case its imports from Madagascar would cease. Madagascar was aware of the problem, which was being considered in the formulation of its investment programs and discussions with the World Bank.

The Executive Board then adopted the following decision:

1. The Fund has received a request from the Government of Madagascar for a purchase of SDR 14.4 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979, as amended).

2. The Fund notes the representation of Madagascar and approves the purchase in accordance with the request.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7742-(84/100), adopted
June 27, 1984

3. NEPAL - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Nepal (SM/84/117, 5/23/84; and Cor. 1, 6/25/84). They also had before them a report on recent economic developments in Nepal (SM/84/129, 6/8/84).

Mr. Panday made the following statement:

On behalf of my Nepalese authorities, I would like to express my appreciation to the staff for their comprehensive and clear assessment of the current situation of the economy and its prospects for 1984/85. My Nepalese authorities are broadly in agreement with the staff's appraisal. They have also asked me to inform the Board that they have already initiated action to delink the cash subsidy for exports from the exchange system to eliminate the emergence of a multiple currency practice.

Overall economic activity in Nepal experienced a serious setback last year due to the drought-induced drop in agricultural output and its adverse impact on other sectors of the economy. Real GDP fell by 1.4 percent. The heavy dependence of Nepal's predominantly agricultural economy on instable weather has subjected the economy to periodic economic dislocations, hindering the realization of the plan objective of rapid improvement in the economic condition of the people. Given the dominant position of the agricultural sector in the economy, the decline in agricultural production had given rise to several economic difficulties, reflected in reduced activity in the nonagricultural sector, a large deficit in the balance of payments, acceleration in the rate of inflation, and budgetary problems by depressing revenues and increasing expenditures on account of relief measures. However, helped by the good monsoon and various productive and stabilizing measures undertaken by the authorities to improve the economic performance, the economy made a strong recovery with indications of improvements in several key areas. Real GDP is estimated to grow by 9.1 percent in the current year. The current account deficit, which rose to 8.6 percent of GDP in 1982/83, is estimated to contract to 6 percent this year. A major gain has been made in controlling the rate of inflation, which is estimated to be 7.3 percent, only half of previous year's level. The public sector deficit is also projected to decrease to 6.5 percent of GDP from last year's 7.9 percent. Significant reduction has also been made in bank borrowing to finance the deficit. My Nepalese authorities are aware of the need for further solid achievements in reducing the dependence of the economy on rain-fed agriculture and improving the performance of the financial and external sectors in order to attain sustained growth in the medium term.

The fiscal year 1984/85 is the last year of the Sixth Five-Year Plan, which aims at securing an annual average growth rate of 4.3 percent. The plan objectives, which are largely guided by a "basic needs" approach, are to stimulate productive activities by expanding investment in agriculture and small cottage industries, improving infrastructural facilities, and expanding employment opportunities. The growth policies in 1984/85 will be oriented toward meeting these objectives. In this respect, the authorities will continue their policy of channeling investment into potentially productive areas by stimulating agricultural production and promoting cottage industries. In 1984/85, 45,000 hectares of land will be developed under an integrated development program by exploiting underground water for irrigation and ensuring the supply of critical inputs. To improve industrial production, the availability of inputs will be ensured via liberal import policies. A modified incentive scheme for exporters will be continued to stimulate production and promote exports. Appropriate adjustments will also be made in administered prices to provide incentives to producers.

Regarding public finance, the fiscal policy has been expansionary since 1981/82, and the public sector deficit peaked at 7.9 percent of GDP in 1982/83. The fiscal developments continue to worry the Nepalese authorities, who closely share the staff's view that the successful realization of the development objectives would greatly depend on the fruitful efforts of the authorities toward mobilizing more resources to finance development programs. Realizing the unsustainability of such large deficits, the authorities immediately introduced various policy measures to improve the fiscal performance. The budget was revised to curtail nonpriority development expendidures by as much as 20 percent and various revenue-raising measures were also introduced. A new bond carrying a 13 percent interest rate has been offered to the public and nonbank institutions to reduce bank borrowing to finance the deficit. As a result, the proportion of deficit being financed through bank borrowing has significantly declined to 2.5 percent of GDP from 6 percent last year. The authorities are committed to take any additional measures necessary to strengthen the fiscal position in 1984/85 and beyond. Accordingly, various proposals and alternative schemes to increase the buoyancy of revenues are under active consideration of the authorities; ways are also being explored to tax the agricultural sector. To assist in these efforts, the Government has sought the technical assistance of the Fund.

The course of monetary policy has been markedly restrictive in 1983/84, due to the need to preserve balance of payments viability and maintain price stability. Consequently, monetary and credit expansion have decelerated significantly in the current year. Broad money is expected to expand by 15 percent, compared with an increase of 24 percent in 1982/83 and is projected to expand by 12 percent in 1984/85. Monetary policy will continue to be restrained and will principally be guided, as in the past, by the objectives of directing credit to priority sectors and preserving the viability of the balance of payments. Interest rates, although they have turned significantly positive as a result of a sharp decline in the rate of inflation, would be maintained at the present level. The authorities have no intention of reducing the interest rates at present. The program of expanding banking facilities to more areas will be pursued vigorously in order to enhance further the major objectives of mobilizing more savings through the banking sector, particularly from the rural areas, and expanding investment in agriculture and small cottage industries.

A new private sector bank with foreign participation has started functioning. The presence of a new bank, managed with foreign collaboration and know-how, is expected to create a more competitive environment and conditions that might enhance the role of the banking sector in promoting the country's growth objectives.

The external sector recorded a substantial improvement in 1983/84. The unfavorable external environment, the drop in agricultural production, and the expansionary financial stance pursued by the Government had adversely affected the balance of payments in 1982/83, pushing the payments position into a deficit of SDR 45.2 million. The adoption of a more flexible exchange rate policy, the improvement in domestic production, and various incentives implemented by the Government to promote exports stimulated the recovery of exports, which are estimated to rise by about 40 percent in the current year. On the other hand, imports slumped as a result of lower demand, reflecting the lagged effect of last year's drought-induced income loss as well as some restrictive measures introduced by the authorities to discourage nonessential imports from third countries. The current account deficit, which widened to 8.6 percent of GDP last year, is estimated to decline to 6 percent of GDP in 1983/84. Further strengthening of the payments position would be essential to advance the growth programs without external constraints. The authorities, therefore, intend to pursue the present policies designed to promote exports while intensifying efforts to increase production in the real sector which, the Nepalese authorities believe, is of paramount importance in achieving a sustained balance of payments position.

On the exchange front, considerable progress has been made in rationalizing the exchange system in Nepal. The abandonment of the dual exchange rate policy with the unification of the exchange rate system in 1981 and the shift made to the trade-weighted basket system in June 1983 were major steps undertaken by the authorities to streamline the exchange system. The

Nepalese authorities have been making necessary adjustments in exchange rates, and the rupee has substantially depreciated in terms of the dollar in the recent period. The authorities are committed to maintain the flexibility of the exchange rate system and to make appropriate adjustments to preserve the external sector and secure the growth objectives. The different trading practices that Nepal has been following with India and other countries have complicated the conduct of the country's trade and exchange policies. The major problem arises from the need to strike an appropriate balance in the accumulation of the inconvertible Indian currency and the convertible currencies. The need to strike appropriate balance stems from two sources: first, because of the proximity of the Indian market and lower transport costs, exports tend to flow to India unless prices are higher in the international market; second, Nepal cannot obtain some of the goods in quantities it needs because of the short supply of these goods in India itself. Therefore, Nepal has to import such goods from other countries against payment in convertible currencies. In order to earn enough convertible currency, Nepal, at times, has to resort to incentive measures to divert exports away from India. The Nepalese authorities believe that adjustment in exchange rates alone may not resolve some of these difficulties, and are in search of an appropriate exchange policy which might serve the country's growth objectives best with minimal cost to the economy. At present, the authorities are convinced that the present exchange policy, aided by fiscal actions as necessary to provide additional incentives for export promotions, is appropriate for serving the economic interest of the country.

As to the prospects for 1984/85, with the report of normal rainfall and the commitment of the authorities to persevere with stabilizatiton efforts, the outlook for 1984/85 appears encouraging.

Mr. Malhotra said he was encouraged to note that Nepal had recovered substantially in 1983/84 from the setbacks it had suffered in the previous year due to the severe drought, which had adversely affected all sectors of the economy. Poor agricultural performance in 1982/83 had dampened overall economic activity; the balance of payments had fallen into deficit, and depressed revenues combined with increased relief expenditures had caused large budget deficits which had fueled inflation. However, the economy had recovered, primarily because of the excellent monsoon but also due to pragmatic measures adopted by the authorities to improve economic performance. In 1983/84, real GDP was estimated to have grown by 9.1 percent, compared with a decline of 1.4 percent in 1982/83. The current account deficit was expected to fall from 8.6 percent to about 6 percent. Furthermore, the public sector deficit and bank financing had also been significantly reduced. Inflation had fallen from 14 percent to about 7 percent.

The Nepalese authorities had taken decisive steps to reverse the expansionary fiscal policy of earlier years, Mr. Malhotra continued. The public sector deficit had been reduced from 7.9 percent of GDP in 1982/83 to an estimated 6.5 percent in 1984; the improvement was significant, but further reductions were necessary in the interest of balanced and noninflationary economic growth. Recognizing the need for fiscal consolidation, the authorities were considering several revenue-raising measures, particularly taxation, some of which had already been adopted. Their efforts to reduce borrowing from the banking sector were also welcome. Furthermore, the authorities were working on a plan to rationalize the financial planning and pricing policies of the public sector enterprises. Among the revenue-raising schemes under consideration for 1984/85 were plans to match revenue raised for local government projects with a contribution from the Central Government, the rationalization of sales and excise taxes, and taxation of the agricultural sector. He hoped that such schemes would enable the authorities to improve their fiscal performance. It was notable that they had curtailed budget expenditure in nonpriority areas by 20 percent in 1984.

The commendable steps taken to restrain monetary expansion had begun to yield results, Mr. Malhotra commented, as evidenced by lower inflation and a modest improvement in the balance of payments. Broad money, which had expanded at a rate of 24 percent in 1982/83, had been contained to 15 percent in 1983/84, and the authorities intended to further reduce monetary expansion to 12 percent in 1984/85. The authorities' commitment to maintaining positive rates of interest was pragmatic, and should help to mobilize a greater volume of domestic savings, as should the expansion of banking facilities in rural areas.

There had been considerable improvement in the balance of payments in 1983/84 in comparison with 1982/83, when there had been a serious decline in exports due primarily to a severe supply constraint caused by the steep decline in agricultural production, Mr. Malhotra continued. Exports had fallen by over 25 percent during that year when compared with 1981/82. Indeed, the value of exports in 1983/84, while increasing substantially from 1982/83, had still been below the level achieved in 1980/81 or 1981/82. Even though the value of imports had declined by about 8 percent in 1983/84, it was still about 10 percent above the 1981/82 level. The reduction in imports had been made possible by an increase in domestic supply, particularly of foodgrains, and by restrictions placed on nonessential imports from third countries. However, although the current account deficit had been reduced from 8.6 percent of GDP in 1982/83 to 6 percent in 1983/84, the balance of payments position was still not sustainable, despite efforts to increase export earnings to finance the necessary imports. Since it was not advisable for Nepal to borrow commercially abroad, the authorities must pursue the present policies with vigor to further strengthen the balance of payments position. He concurred with their view that export promotion and improved efficiency in the productive sector were particularly important for achieving medium-term balance of payments viability.

The authorities had been pursuing a pragmatic and flexible exchange rate policy, Mr. Malhotra noted, which they intended to continue. That the Nepalese authorities were unwilling to risk a depreciation of the rupee for fear of rekindling inflation was understandable, given the supply constraints within the Nepalese economy. To improve the balance of payments position in the medium term, production as well as productivity should be increased, particularly in the agricultural sector, which provided a large proportion of Nepal's exports.

Mr. Hirao commented that the Nepalese economy had rebounded strongly in 1983/84 from its drought-induced decline of the previous year. Real GDP was estimated to have increased by 9 percent, while inflation had moderated considerably. Although the results were partly due to favorable weather, leading to good crops, the authorities should be commended for taking appropriate economic measures.

On fiscal policy, Mr. Hirao noted that revenue was expected to increase by almost 18 percent in 1983/84, reflecting buoyant economic activity and the impact of new revenue measures and improvements in revenue administration. He commended the authorities for implementing the measures announced in 1982/83, which had included increases in income taxes in higher brackets and in automobile registration and user fees. Also welcome had been the notable increases in the operating surpluses of some public enterprises. Moreover, the growth rate of expenditures was expected to decelerate sharply to about 6 percent in 1983/84 from over 26 percent in the previous year, reflecting in part the suspension of many lower-priority, nonaid-financed development projects and the deferment of salary increases for government workers. The steps were appropriate, with the result that domestic bank financing of the budget deficit was expected to decline sharply from 6 percent of GDP in 1982/83 to 2.5 percent in 1983/84. If it were realized, the reduction would be an impressive achievement that should further contribute to the containment of inflationary pressures. However, the staff was concerned about bank financing, which was already in excess of NRs 500 million during the first half of 1983/84. Although the rapid expansion of bank financing partly reflected the seasonality of domestic revenue, developments in the area should be closely monitored. He asked the staff for its most recent estimate of bank financing in Nepal. He strongly supported the recent request from the authorities for technical assistance from the Fund in the area of tax policy.

Concerning monetary policy, Mr. Hirao said that the authorities should be commended for maintaining constant nominal interest rates in spite of the sharp decline in the rate of inflation in 1983/84, since the resulting positive interest rates had no doubt contributed to the successful sales of national savings certificates. He agreed with the staff that it would also be desirable to raise the real interest rate on shorter-term bank deposits and on treasury bills to positive levels.

The balance of payments position in Nepal had improved considerably in 1983/84, Mr. Hirao stated. Total exports were estimated to have expanded by 25 percent, while imports were expected to decline by 8 percent following a large expansion in the previous two years. The current account, excluding aid-financed imports, had been approximately in balance. However, the staff expressed concern that the balance of payments could weaken over the medium term unless there were sustained improvement in export performance, suggesting that a more active exchange rate policy would be appropriate. Although the authorities' argument that depreciation of the exchange rate would lead to an increase in inflation without benefiting the external account was understandable, the staff's argument that a more active exchange rate management policy at present would expand the medium-term scope for a supply response, although initially it would be very small, was also highly convincing. Overall, the medium-term balance of payments projections on pages 11-13 of SM/84/117 were not promising; end-of-period reserves in 1989/90 would be equivalent to less than one month's imports. The authorities should therefore consider the staff's suggestion for a more active exchange rate policy, which they should implement as soon as possible. He concurred with the staff that recourse to commercial borrowing was not a viable option for the management of Nepal's current balance of payments deficit.

On supply-side policies, Mr. Hirao said that he welcomed the continued efforts of the authorities to improve agricultural productivity, including those to increase irrigation facilities, to distribute chemical fertilizers, and to improve seeds. In the realm of industrial policy, the authorities' aim of encouraging export-oriented as well as import-substituting cottage industries was appropriate, although success would require adequate coordination between the relevant ministries. In conclusion, he supported the proposed decision.

Mr. Salehkhou said that he welcomed the staff's inclusion of a paragraph in SM/84/117 summarizing the gist of the Executive Board debate in the 1983 Article IV consultation discussions with Nepal. He hoped that the staff could continue the practice in future country reports. However, the absence of a section reporting discussions between the mission and the Nepalese authorities was surprising; the authorities' views on policy issues were cited only with respect to exchange rate policy, where they had apparently taken a different view from the staff.

The Nepalese economy had made a welcome recovery in 1983/84 after the 1.4 percent decline in real GDP in the previous year when severe drought had adversely affected agricultural production, Mr. Salehkhou continued. Because of the dominant position of agriculture in the economy, subsequent favorable weather had led to a strong recovery of crop production, especially rice and foodgrains, leading to an estimated increase in real GDP of over 9 percent in 1983/84. The bumper harvest had also helped to reduce inflation to about 7 percent. Clearly, the prospects for 1984/85 would also hinge on favorable weather conditions.

In the external sector, Mr. Salehkhou noted that exports had recovered sharply while imports had declined, both as a result of buoyant agricultural production. However, official transfers and receipts from the tourist industry had declined, with serious implications for the economy, since tourist receipts accounted for over 50 percent of total export value. Nevertheless, the trade deficit had narrowed considerably in 1983/84.

The budgetary developments were satisfactory, Mr. Salehkhou said, although greater efforts were needed to reduce further the overall deficit, which was about 6.5 percent of GDP. The authorities' decision to curtail domestic bank financing was particularly noteworthy. They also planned to raise budgetary revenue. Less promising was the slow growth of development expenditure, which had risen by only 2.3 percent in 1983/84, after a rise of 36.6 percent and 27.6 percent in 1981/82 and 1982/83, respectively.

Concerning monetary policy, Mr. Salehkhou noted that bank credit to the private sector had expanded more rapidly in 1983/84. Lower inflation and relatively greater positive real interest rates should stimulate savings.

More information was needed to reach a judgment of the value of continuous exchange rate adjustment in Nepal and its possible effects on external competitiveness, Mr. Salehkhou said, particularly on the structure of wages, the relative prices of tradable goods, and the relative importance of the manufacturing sector. The information available in the report on recent economic developments indicated that wages were relatively low and that prices were sensitive to the Indian price level. Moreover, the manufacturing sector was based on import substitution, was closely linked to agriculture, and was relatively small. The export-oriented sector consisted of small cottage industries producing carpets and handicrafts that were owned by small-scale private concerns. Since 1981 Nepal had been depleting its foreign exchange reserves. Given the above characteristics, he requested the staff's comments on the relative price structure of the two sectors. Overall, there appeared to be no pressing need for substantial exchange rate correction, particularly given the low inflation rate, although comments from the staff on the issue would be welcome and he stood ready to be convinced otherwise.

He agreed with the staff that, in order to consolidate short-term gains, steps should be taken to strengthen the structure of the economy and the balance of payments over the medium term, and to monitor fiscal and monetary developments, Mr. Salehkhou continued. However, in addition to the normal steps a country should follow, Nepal and many African countries that were critically dependent on agriculture should plan for abnormal drought conditions well in advance by improving planting methods, establishing contingency reserves of food and water, and setting up reliable early warning systems. The problem was, of course, more the concern of the World Bank, but the staff's comments on the feasibility of such steps in Nepal would be welcome.

Reference was made in the proposed decision to Nepal's multiple currency practice, Mr. Salehkhou recalled. According to Decision No. 6790-(81/43), adopted March 20, 1981, the Fund did not approve practices involving discrimination among Fund members. However, for pragmatic reasons, the Fund did retain some flexibility to approve a multiple currency practice that was temporary or when the authorities presented logical evidence for its retention. In fact, members were already authorized within the existing body of rules and decisions, with permission from the Fund, to retain discriminatory trade restrictions. However, he wished to know whether, for legal reasons, the decision on multiple currency practices catagorically prevented the Board from approving any such practice involving discrimination. If the Board could not grant temporary approval in specific cases without amending that decision, as suggested by the staff report, then the question must be asked as to why discriminatory multiple currency practices should be subject to categorical rejection but not other forms of trade restriction. For example, according to Decision No. 955-(59/45), adopted October 23, 1959, temporary approval could be granted for discriminatory exchange restrictions for balance of payments purposes, and exchange restrictions for security reasons were also exempted. The implicit distinction made between multiple currency practices and other forms of exchange restriction brought to light an inconsistency in the Fund's approach to trade restrictions. He supported the proposed decision.

Mr. Grosche commented that Nepal had recovered quickly from the last drought, owing to improved microeconomic policies. However, the short-term gains needed to be consolidated, requiring the pursuit of a prudent policy stance. Since agriculture would continue to be the backbone of the economy, a high priority was to strengthen production and productivity in that sector, particularly since the declining exportable agricultural surplus was a major cause for concern. The future of agricultural exports depended in part on the exchange rate, but it also depended on the adequacy of support prices and on finding the right level of subsidy for fertilizers and irrigation. Currently, support prices were announced too late and were below market levels. Close cooperation with India concerning pricing decisions would be advisable, given Nepal's unique geographic position and its close economic links with India. He requested comments from the staff on agricultural pricing.

The general stance of fiscal policy reflected the commitment of the authorities to create a stable economic environment as the basis for sustainable growth, Mr. Grosche continued. Nonetheless, the revenue base had to be broadened, and he urged the authorities to pursue the policy initiatives currently underway and to seek their timely implementation. The performance of the nonfinancial public enterprises had improved considerably in 1983/84, but there was scope for more autonomy, particularly in price setting. He welcomed both the reduction and tighter monitoring of net government lending to the public enterprises. Also encouraging was the introduction of national savings certificates, which had helped to reduce government borrowing from the banking sector.

Concerning monetary policy, the high degree of liquidity in the economy was still a cause for concern, Mr. Grosche said. However, the reduction in inflation had already raised longer-term real interest rates and should allow for positive real interest rates over the whole maturity spectrum.

He supported the staff in its arguments for the adoption of a more active exchange rate policy in Nepal, Mr. Grosche remarked. The exchange rate was of particular importance in a small economy in that it regulated price signals and other incentives. A unified and more active exchange rate policy could also effectively substitute for import licenses, import fees, and other trade policies. One argument against an active exchange rate policy was that it was severely impaired by supply constraints. Clearly, much could be said on the subject, but it was interesting to note that irrigated land in Nepal was being operated below full capacity, suggesting that there was at least no supply constraint for that factor of production.

The case for a more active exchange rate policy was strengthened by the gloomy medium-term balance of payments outlook, Mr. Grosche continued. The projections indicated continuous and increasing strains on the balance of payments during the coming years, with a steadily rising current account deficit. A more flexible exchange rate policy would certainly be beneficial in stimulating the sluggish export performance, which would, of course, be further improved by sound financial policies.

Foreign indebtedness did not seem to be a problem in Nepal, Mr. Grosche said, since it had been contracted under concessional terms. However, Nepal had experienced difficulty in implementing large multidonor projects; he requested more specific comment on the matter from the staff, since Nepal would depend for some time on the availability of foreign aid flows, which should not be endangered by problems which might arise in the implementation of development projects. He supported the proposed decision.

Ms. Bush said that Nepal had rebounded from the recession of 1982/83, combining rapid real growth with declining inflation. Nepal's record during 1983/84 demonstrated clearly both the efficacy and desirability of pursuing moderate fiscal and monetary policies. The turnabout in Nepal's balance of payments and the renewed strength of its exports were encouraging, although future gains in exports should be based more on improvements in quality and value than on recourse to distorting subsidies and tax rebates.

Although Nepal's progress in many economic areas had been commendable during 1983/84, Ms. Bush continued, immediate attention should be paid to the Government's management of its current expenditures, which had increased by 60 percent in 1983 due to growing spending on public administration and miscellaneous items. The resulting strain on financial resources was significant. The public sector enterprises also continued to undermine fiscal health, since successively generous subsidies drained the Treasury and hindered the efficient allocation of scarce resources.

It was encouraging that the decline in inflation combined with constant nominal interest rates had moved real rates on long-term deposits from negative to positive, since it would effectively stimulate private saving, Ms. Bush commented. She hoped that the positive real rates would be maintained and that the rates on short-term deposits would also soon be raised to positive levels. Interest rates that reflected the true cost of generating investment funds would contribute to a more efficient allocation of productive resources.

The discouraging medium-term balance of payments projections included in the staff report should serve as a useful warning to the authorities, Ms. Bush remarked. They were based on optimistic assumptions regarding aid inflows, export growth, and demand management, and showed that any deviation from prudent economic policies could lead to rapid deterioration in Nepal's internal and external economic situation. The authorities should pursue development programs in a pragmatic and prudent manner, recognizing that some of the more optimistic assumptions might not materialize. In addition, although commercial credit should still be used for commercially viable projects, Nepal should continue its policy of avoiding potentially burdensome short-term commercial bank funding for the financing of the balance of payments deficit, since Nepal's export base was thin, with limited prospects in the short term for either rapid growth of existing exports or the development of new ones.

The projected lack of strength in Nepal's export sector threw doubt on the adequacy of Nepal's exchange rate policy, Ms. Bush stated. The authorities should pursue an exchange rate policy that would strengthen the balance of payments. An appropriate exchange rate would give the price signals necessary to spur the growth and development of the export sector. A process of development based on exchange rate flexibility might be slow, but it was nonetheless important to begin it immediately.

Miss Bulloch noted the encouraging development in the Nepalese economy during 1983/84 following the improvement in climatic conditions. Real GDP was expected to grow by about 9 percent, although from a low base, and inflation had been halved to 7 percent, reflecting not only the growth in food supplies but also a strengthening of financial management. Moreover, the balance of payments position had improved. However, it was clear from the staff report that severe structural problems remained that complicated the management of the Nepalese economy; technical assistance had an important role to play in mitigating them. For example, the authorities' request for assistance from the Fund in the area of tax policy, and provision of technical aid in project monitoring and evaluation by the World Bank, were welcome.

Clearly, close cooperation between the Fund and the World Bank was essential, Miss Bulloch continued, and was facilitated by the presence in Nepal of resident representatives from both the Bank and the Fund. She would have liked to see a fuller discussion in the staff report of the objectives of World Bank Group lending to Nepal, and of how it fitted into the supply policies and development planning of the authorities.

Given the potentially important contribution of the World Bank Group to Nepal's future development, the Bank should be consulted regularly in future Article IV consultations, particularly since its staff would shortly be evaluating Nepal's Seventh Five-Year Plan.

The staff representative from the Asian Department said that by mid-April 1984, or three quarters of the way through the fiscal year, bank financing to the Government had been NRs 636 million against a revised target of NRS 640 million for the fiscal year as a whole.

Although the report did not include a separate section entitled "policy discussions with the authorities," the staff representative explained, the discussions with the authorities were covered in full in the "current policies" section, which also contained a lengthy consideration of Nepal's medium-term prospects.

There certainly was a problem of insufficient data on wages and relative prices of tradable and nontradable goods, the staff representative noted. Although developments in the real effective exchange rate were known, they might be less useful for Nepal than for some other countries because of the heavy weight of tradable goods from India in Nepal's consumer price index. It was particularly difficult to construct an index of nontraded goods prices in Nepal, since the nontradable sector consisted essentially of wages, public utilities, and services. Instead, certain items from the consumer price index, mainly services, had to be selected as indicators of price movements in nontradable goods. On that basis, the data indicated that the ratio of the prices of tradables to nontradables had declined, although not by a significant amount. Perhaps a more direct indicator of the profitability of the export sector was the ratio of the unit value of exports to an indicator of nontradable prices in Nepal, or possibly even to the consumer price index itself. Using that measure, the profitability of exports appeared to have decreased significantly over the period 1979-83. However, whatever measure was used, it was clear that exports had stagnated in recent years, despite the skillful use of trade policy and the implementation of various multirate systems. It was important that the trend be arrested and reversed.

As for the scope for improving the efficiency of supply-side policies, and the means by which Nepal might protect itself against drought, the staff representative remarked, the staff had held discussions on the issue with the Food and Agriculture Organization and with the World Bank representative in Nepal; also, the Asian Development Bank had undertaken a study on agricultural prospects and policies in Nepal. The overall consensus was that the authorities were giving appropriate support to the agricultural sector in its development plan, through major investments in irrigation, the provision of shallow-tube wells to farmers on a subsidized basis, and the provision of improved seeds and fertilizers. However, there were managerial and domestic resource constraints to agricultural development, some of which had arisen from the policies themselves. For example, one reason advanced for the slow growth in fertilizer use in agriculture in recent years was that the subsidy allocated by the Government had been so high that the Government could not afford to import enough fertilizer. There was clear scope for improvement in policy implementation.

Concerning drought protection, the staff representative noted that the authorities had ensured an accumulation of foodstuffs under their food security scheme as a short-run measure, while, in the longer run, they were attempting to increase significantly their food storage capacity through cooperation with the World Bank and other lenders. Such measures should alleviate the kind of problem that emerged during the 1983 drought.

There had also been a question about problems in project implementation, the staff representative recalled. The primary problem was a lack of skilled labor, and in particular a lack of management skills. Nepal faced serious transport difficulties, in that the bulk of its imports for the development projects had to be transported long distances over difficult terrain. Furthermore, there were lags in transporting the imports as far as the Nepalese border. The Nepalese authorities and the World Bank were making strenuous efforts to improve the rate of project implementation, but they were sometimes frustrated by a shortage of counterpart funds. The authorities had now taken the wise step of budgeting in advance for counterpart funds for such purposes.

There was extensive cooperation between the Bank and the Fund through the aid consortium, which was chaired by the World Bank, through mutual consultations before and after each mission, and meetings between the Fund and the Bank in the field, the staff representative commented. The Bank had been highly active in Nepal in a number of areas, and had published a major report of its own at the end of 1983. Perhaps in future a more detailed summary of the Bank's activities could be included in the staff report.

The staff representative from the Exchange and Trade Relations Department recalled that Mr. Salehkhou had raised a question concerning the Fund's policy on the approval of discriminatory multiple currency practices. The question had both policy and legal implications. From the standpoint of policy, the Fund did not normally approve discriminatory practices or restrictions. The policy was uniformly applied to multiple currency practices or to any other discriminatory features that might exist in the exchange arrangements of members. The legal aspects of Mr. Salehkhou's question would be addressed by the staff representative from the Legal Department.

The staff representative from the Legal Department noted that Mr. Salehkhou had raised two pertinent questions concerning the multiple currency practice, one relating to its policy aspects, the other to its legal aspects. The latter question raised the issue of the legal relationship between the Fund and a member country when the Fund had adopted a general policy on a certain issue. The example under discussion was the 1981 decision on multiple currency practices, which had established the Fund's general policy toward such practices. Whether the Executive Board might exempt a member country from the operation of that policy without amending the decision was a particularly relevant question. Clearly, the authority of the Executive Board was sovereign in that it could decide upon the principles, rules and procedures to apply either generally or in a particular instance. Thus, there had been occasions when the Board had decided to make an exception from the operation of a general policy; for example, on the use of Fund resources. The consequence was, of course, that the general policy was not applied equally, raising the question of the equality of treatment of members and of the importance attached to the precedent set by a particular deviation from the general policy. It also raised the somewhat esoteric question as to whether the general policy was in fact general.

Referring to Mr. Salehkhou's question concerning the policy of approving exchange restrictions, the staff representative replied that it was best addressed from a historical perspective. When the earlier decision on multiple currency practices had been taken in 1960, there had been a reference to multiple currency practices that had not included mention of discriminatory features. However, in the two Executive Board papers on multiple currency practices in 1979--a policy paper and a legal paper--references to discriminatory features had increased. In the 1981 decision, discrimination in multiple currency practices had been highlighted, reflecting the trend in their use. The decision of the Executive Board following discussion of the 1981 paper had dealt only with multiple currency practices rather than with exchange restrictions in general; the policy was therefore made specific to multiple currency practices. However, concerning discriminatory exchange restrictions for balance of payments purposes, the staff had in practice not recommended their approval; in fact, discrimination in the imposition of exchange restrictions would normally prevent their approval. In the light of the substantial experience and practice over the past two decades on discriminatory restrictions for balance of payments purposes, the contrast drawn by Mr. Salehkhou between the Fund's approach to discriminatory multiple currency practices on the one hand, and to discriminatory exchange restrictions on the other hand, would appear to be more apparent than real.

The Chairman made the following summing up:

Directors generally supported the thrust of the staff appraisal in the report for the 1984 Article IV consultation with Nepal. They noted that, with favorable weather, Nepal's economy had strongly rebounded in 1983/84 from the drought-induced setback in the previous year. With improved food supplies and tighter demand management policies, inflation had moderated considerably and the balance of payments situation had improved significantly. Directors commended the Nepalese authorities for their success in reducing government borrowing from the domestic banking system and the resulting progress toward financial stability.

Directors stressed that fiscal and monetary policies should continue to be restrained in 1984/85, in order to sustain the progress made in 1983/84 toward strengthening the economy and the balance of payments. In this connection, they welcomed the authorities' intention to implement new revenue measures and to vigorously pursue improvements in tax administration and efforts to rationalize the financial planning of public enterprises. Nonetheless, short-term revenue prospects underscored the need for continued expenditure restraint, especially in the field of subsidies. Directors also recommended more flexibility in price setting by public enterprises. Further reduction in government borrowing from the banking system would permit bank credit to the private sector to expand in line with expected economic activity, without threatening inflation and short-term balance of payments objectives.

For the medium term, Directors expressed the view that attainment of developmental goals and the strengthening of the balance of payments required sustained progress in raising productivity in agriculture, the source of most exports, and greater efforts to mobilize domestic and external resources. In this regard, Directors emphasized the need for the formulation and timely implementation of measures to increase government revenue. With respect to private resource mobilization, several Directors noted that the process should be helped by the authorities' policy of maintaining interest rates which were significantly positive in real terms. It was also hoped that interest rates on short-term bank deposits and on treasury bills would become positive in real terms. A continued strengthening of administrative capacity appeared necessary to accelerate the implementation of development projects and the associated utilization of external aid.

Directors welcomed the improvement in Nepal's external position in 1983/84. However, taking into account Nepal's medium-term balance of payments and development prospects, a number of Directors considered that a unified and adequately active exchange rate management policy, in conjunction with policies to stimulate agricultural production, would serve to enhance Nepal's export prospects and thus strengthen its balance of payments over the medium term. Directors urged the authorities to remain cautious in their debt management policy and their recourse to commercial borrowing.

It is expected that the next Article IV consultation with Nepal will be concluded by November 1985.

The Executive Directors took the following decision:

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

2. Nepal maintains a multiple currency practice as described in SM/84/117 and SM/84/129. The Fund encourages Nepal to eliminate the multiple currency practice as soon as possible.

Decision No. 7743-(84/100), adopted
June 27, 1984

4. VANUATU - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Vanuatu (SM/84/116, 5/22/84; and Cor. 1, 6/22/84). They also had before them a report on recent economic developments in Vanuatu (SM/84/133, 6/13/84).

Mr. Prowse made the following statement:

The Vanuatu authorities agree with the thrust of the staff's assessment and recommendations.

In considering this, the second Article IV consultation with Vanuatu, it may be helpful to recall here the emphasis of the first consultation on the fact that Vanuatu is a relatively poor, small-island economy. In particular, there are structural factors in the Vanuatu economy, both physical and institutional, which may not be altogether amenable to conventional analysis and treatment. Such matters as the management of liquidity, and the market for local currency-denominated bank lending may be cases in point. Of course, Vanuatu is not only a small-island economy, it is also a newly independent economy struggling with all the implications of independence for its fiscal policies.

The Vanuatu authorities have reason for satisfaction over the economic progress achieved since the country's independence in 1980. The table below gives some indication of the achievements in output, price restraint, and the external account:

	1981	1982	1983
GDP growth (In percent)	1-2	2-3	3-4
Inflation (overall CPI) (In percent)	27.4	6.2	1.7
Current account surplus (As percent of GDP)	37	27	23

These notable, though still fragile, gains reflect, inter alia, favorable developments in the price of copra (70 percent of Vanuatu's total exports), and continuing substantial foreign grants (principally from the United Kingdom and France). As the staff say, this success has also been due to the policies pursued by authorities to imporve the quality of exported copra, and to stimulate strong activity in the tourism and construction sectors through progress in resolving land tenure questions. It may be useful to briefly recount these policies and policy intentions for the future.

In the fiscal policy area, the overall budget deficit was brought down from VT 322 million in 1982 (4 percent of GDP) to VT 49 million in 1983 (0.6 percent of GDP). This was achieved despite a VT 730 million (9 percent of GDP) drop in foreign assistance (in line with the "phasedown" understandings), through an 18 percent increase in revenues and a 16 percent cut in expenditures. In this respect, the authorities note that the comment in paragraph 1, page 10 of the staff report should recognize the role of departments in containing expenditures, as well as the firm control exercised over development projects in general.

The authorities are keenly aware that a major challenge for the next five years is the programmed further decline in grants for recurrent purposes from the former colonial powers, with the last payments expected in 1988. In working toward fiscal independence, the authorities are targeting a budget surplus in 1984 by raising revenues by a planned 17 percent, while expenditures will be allowed to grow by only 7 percent. The authorities note the staff's concern over the prospective increase in recurrent budget expenditures, but they point out that the prospective increases in these expenditures result in large part from the unavoidable impact on budget outlays of increases in overseas-assisted development activities.

In the industrial and trade policy areas, I believe the authorities have shown much ingenuity and vision in exploiting available opportunities in circumstances where options are clearly limited. An example is the installation of hot-air dryers for some of the copra crop, which evidently has resulted in an improvement in the quality of this copra, resulting in a 12 percent increase in the export price. Diversification in export products is also being promoted. Agricultural diversification is important, but diversification objectives extend beyond that; efficient import substitution is under active consideration. The newly established cement plant is a good example of such import substitution; it uses mostly local inputs, saves transport cost on a bulk item, and has strong linkages with the construction sector.

The Finance Center is an example of diversification within a limited range of opportunities, but the authorities suggest that the importance of the contribution of the Finance Center may be overemphasized in the staff report since their own estimates suggest it accounts for only some 4 percent of recurrent budget revenue and less than 2 percent of total revenues and grants.

The revaluation of the vatu by 5.6 percent in March 1984, leading to a deceleration in inflation without evident impairment of external account objectives, is an interesting example of the use of a flexible exchange rate policy. The authorities continue to be committed to exchange rate flexibility (in both upward and downward directions, as may be appropriate), and to that end will vigilantly monitor developments in the external accounts. However, the authorities suggest there should be no reason to assume a priori that the medium-term impact of revaluation on the balance of payments must be adverse, as seems to be implied in the staff report.

On monetary issues, the effect of interest rate differentials on flows of funds remains uncertain. There is certainly a respected view that argues structural causes to have been more important than the staff (on page 3 of SM/84/116) seems to accept. As for central bank operations, the authorities have no significant disagreement in principle with the staff, but there are some practical difficulties to be overcome. The relationship between the Central Bank and the Banque de l'Indosuez de Vanuatu (BIV), the principal commercial bank, is very important, especially for the conduct of future foreign exchange operations. Unfortunately, a dispute between the Central Bank and BIV following the revaluation is unresolved and is now effectively sub judice pending independent arbitration, but we are hopeful that this will be resolved satisfactorily. Again, concerning the issue of vatu-denominated securities by the Central Bank, the problems to be resolved are those of a practical and institutional kind, rather than of principle.

The difference in views on some issues indicated above should in no way be considered to detract from the appreciation the Vanuatu authorities have for the work done by the staff mission, which they characterize as having been carried out "with a delicate and successful combination of competence, diligence, incisiveness, and diplomacy."

The authorities agree with the staff proposal that the next Article IV consultation with Vanuatu take place on an 18-month cycle.

He wished to emphasize the importance placed by the Vanuatu authorities on both their membership in the Fund and on the Article IV consultation process, Mr. Prowse added. The report on recent economic developments was highly valuable to the authorities, since it provided the most comprehensive evaluation available of the Vanuatu economy.

Mr. Robinson said that he could endorse the staff appraisal. The Vanuatu economy continued to perform well; real GDP growth was about 3-4 percent, the balance of payments was in surplus, and inflation, although accelerating slightly at the end of 1983, remained low. As noted by both the staff and Mr. Prowse, favorable external circumstances in 1983 had contributed to the good economic performance, but the pragmatic and effective policies of the Vanuatu authorities had also played an important role.

There would, however, as the authorities were of course well aware, be a need in the medium term for a substantial adjustment in fiscal policy to offset the reduction in external grant aid, Mr. Robinson continued. Expenditure restraint would be important, but in particular further measures to raise revenue and perhaps to improve the buoyancy of the tax system would be required. There would be concomitant pressure on the external sector, and the staff's cautions about the medium-term dangers of the recent appreciation of the vatu were appropriate, particularly given the authorities' development strategy of encouraging agriculture-based exports and import substitution.

Overall, the problems faced by Vanuatu were more problems of development than of adjustment, Mr. Robinson said. Remoteness, fragmentation, shortages of skilled and unskilled labor, and an overdependence of exports on one commodity, copra, were particularly acute difficulties. Moreover, on an island of only 125,000 inhabitants, over 100 languages were spoken, creating a communication problem second only to that of Papua New Guinea, where over 700 languages were spoken. As noted by Mr. Prowse in his statement for the 1983 Article IV consultation with Vanuatu, such problems suggested that the World Bank and the Asian Development Bank would have a leading role to play. He would therefore have welcomed in the staff report a fuller discussion of the Bank's current and prospective involvement in Vanuatu; comments from the staff or Mr. Prowse concerning the development problems faced by Vanuatu would be welcome.

The authorities' approach to fiscal policy had in general been commendably prudent, Mr. Robinson remarked, particularly their achievement in keeping the recurrent budget in surplus while grants had fallen from 50 percent of recurrent revenue in 1980 to a projected 18 percent in 1984. On the expenditure side, the slippages in expenditure control in 1983 were a cause for concern, suggesting that the authorities should continue to strengthen their monitoring of budgetary expenditure, particularly the wage bill. However, the main challenge facing the authorities would undoubtedly be the raising of new revenues in the medium term. One possibility not mentioned in the staff report, but suggested by a previous technical mission, could be the introduction of an income tax, although the arguments for or against it were not conclusive. Possible counterarguments were that an income tax might affect Vanuatu's status as a tax haven--although other tax havens did have income taxes--and that it might be of relatively limited scope, given the dualistic nature of the economy. On the other hand, the authorities might find it useful to have an explicit and controllable means of income redistribution at hand as external budget aid fell. He would be interested to hear the views of the staff or Mr. Prowse on the possible introduction of an income tax.

Concerning monetary policy, Mr. Robinson said that, although he endorsed the enlarged role suggested by the staff for the Central Bank, it would be important not to rush the process. The Central Bank had made substantial progress in the first three years of its existence and, given the shortage of skilled manpower, its assumption of the role of government banker and reserve manager should be a gradual and cautious process.

He agreed with the staff that streamlining of the land tenure system was urgently required to restore the confidence of potential foreign private investors in the agricultural sector, Mr. Robinson continued. However, experience elsewhere had demonstrated that land reform was a difficult task and that progress would necessarily seem slow. Furthermore, the shortage of skilled labor posed a significant constraint. Expenditure on education, constituting over one quarter of total recurrent expenditure, had fallen slightly as a percentage of total expenditure in recent years. Ten percent of education expenditure was devoted directly to vocational training and thus to the immediate relief of bottlenecks; there was perhaps scope for the allocation of more funds to that area. He looked forward to the recommendations of a recent World Bank mission to Vanuatu that had examined education expenditure. He hoped that education could be covered by the next Article IV consultation, possibly in the report on recent economic developments.

Mr. Hirao remarked that Vanuatu was a small open economy in which the external sector was large in relation to GDP; its main sources of foreign exchange earnings were limited to tourism and the export of copra. The dependence of such a small open economy on the export of a single primary commodity might cause economic instability, while limited labor and capital resources made it difficult to diversify the economic base. Nonetheless, the Vanuatu economy had performed well since independence in

1980 and he commended the authorities for their prudent economic management, which was largely responsible for the economy's success. He broadly endorsed the staff appraisal.

In the realm of fiscal policy, Mr. Hirao noted that the Government was facing the challenge of making further fiscal adjustments, necessitated by the decline and eventual cessation of foreign grants to finance recurrent budgetary expenditures. Efforts to streamline expenditure and to raise revenues would continue to be an important policy objective. An important element in moderating the growth of fiscal expenditure would be restraint in the expenditure on wages and salaries, which constituted more than half of recurrent expenditure. The recent ban on the recruitment of new public servants was therefore welcome, although it was crucial to avoid a rapid increase in the number of staff once the ban was lifted. The projected growth rate of 7 percent in recurrent budget expenditure in 1984 appeared reasonable, given the expected rates of growth and inflation. The authorities should make serious attempts to contain expenditure growth at that level.

The authorities had already taken a number of revenue-raising measures, Mr. Hirao continued, but there was still substantial scope for substituting tax revenue for external grants in the near future. He concurred with the staff's view that the authorities needed to broaden the tax base and to increase tax elasticity, a difficult task given the openness of the economy, which made the tax structure heavily dependent on trade-related tax revenues. Furthermore, if Vanuatu were to continue to benefit from offshore banking activities, the scope for expanding the domestic tax base might be limited. Several suggestions were made in the staff paper, including the introduction of a tax on domestic production. He asked the staff to elaborate on the means by which the authorities could increase their revenues.

He was pleased to note that the authorities had successfully completed the currency exchange operation, Mr. Hirao said. In order to expand further the use of the vatu as legal tender, the Central Bank could encourage the banks to phase out foreign currency-denominated loans. It was a cause for concern that the commercial banks were exposed to undesired exchange risks due to imbalances in the currency composition of assets and liabilities. The Central Bank should provide commercial banks with a facility to adjust their foreign currency positions; the introduction of interest-bearing assets denominated in vatu, as suggested by the staff, therefore deserved further consideration. He concurred with the staff that the Central Bank should assume management of the national foreign reserves and should engage in foreign exchange operations as soon as possible, owing to the need for a more active use of exchange rate policy. The Fund could play an important part in expanding the role of the Central Bank through the provision of technical assistance.

Export earnings had increased substantially in 1983, due partly to the recovery in the world price of copra but also to an improvement in its quality, Mr. Hirao noted. The authorities' efforts to improve export potential were welcome, and their intention to use exchange rate policy primarily as an instrument for controlling inflation was understandable, given the openness of the economy. The inflation rate had been kept satisfactorily low in recent years. However, the impact of exchange rate movements on the balance of payments should be given due consideration. It was particularly difficult to assess the impact of the recent revaluation of the vatu on the external position over the medium term; the authorities should monitor closely external developments and take prompt action as necessary. Given the prospective reduction in foreign grants, the importance of exchange rate policy as a means for external adjustment might increase in the future.

Ms. Bush said that she was in broad agreement with the staff appraisal and supported the staff's policy recommendation. Considering Vanuatu's vulnerability, the economy had performed well over recent years. However, due to that vulnerability, it remained necessary for the authorities to anticipate unexpected change by allowing for a margin of error and by considering contingent options. Optimism about the prospects for achieving the desired economic objectives in the medium term was appropriate so long as the Government continued to exercise prudence.

In the area of fiscal policy, Ms. Bush agreed with the staff that, given the decline in foreign grants, the authorities must exercise budgetary restraint.

Regarding trade policy, the authorities should be wary of reliance on world price increases to supplement export revenue, Ms. Bush continued. She therefore welcomed their plan to continue improving the quality and quantity of copra exports and promoting other traditional agricultural exports, while continuing to develop the service sector. To encourage private investment in the agricultural sector, efforts should be made to further the implementation of the legal and administrative framework for registering rural land leases, although an excessively complex framework could discourage private investment.

On exchange rate policy, Ms. Bush shared the staff's concern that the recent revaluation of the vatu against the SDR could have adverse long-run effects on the balance of payments, although she noted the authorities' intention to monitor the balance of payments closely, and to follow a flexible exchange rate policy.

Mr. Nguyen said that Vanuatu was a success story, in contrast to many of the countries discussed by the Board. The Vanuatu economy had displayed satisfactory performance both domestically and externally, for which the authorities should be warmly commended. However, as noted by Mr. Prowse, the results were still fragile, given the heavy dependence of the economy on developments in copra prices and capital inflows. He therefore welcomed the authorities' decision to implement an active industrial and trade policy in order to stimulate export diversification, import substitution, and tourism. He endorsed the staff's emphasis on the importance of a flexible exchange rate policy.

He noted with satisfaction the useful technical assistance provided by the Fund and also the credit from the World Bank, Mr. Nguyen added.

The staff representative from the Asian Department recalled that several Directors had asked about the staff's view on how the authorities could increase revenue in the future. In 1981, the Fiscal Affairs Department had provided technical assistance to Vanuatu, and had produced a report recommending several revenue-raising measures. In the short run, they had recommended increases in existing taxes--such as company registration fees, tariffs, and rents on government houses--and the levying of taxes on hotel and restaurant services. In the long run, they had recommended that an income tax should be introduced. Judging from the authorities' achievements in recent years, most of the short-term measures had been implemented, but long-run measures had yet to be taken. Owing to administrative bottlenecks and shortages of skilled manpower, the introduction of an income tax could not be foreseen in the very near future, but the authorities were considering it for the longer run. Meanwhile, as argued by the staff at the time of the 1983 Article IV consultation, the authorities should consider the introduction of a domestic production tax--the taxation of domestically produced goods, as opposed to the taxation of goods produced outside the country. Although the manufacturing sector in Vanuatu was very small, the authorities were attempting to introduce import substitution industries, such as clothing, cement, and soft drinks, on which it would not be difficult, from an administrative point of view, to introduce a domestic production tax. The experience derived from taxing a few domestically produced goods could help the authorities eventually to formulate the introduction of a successful income tax.

The World Bank had been very active in Vanuatu, and had agreed on a project to improve the agricultural sector, to be cosponsored by the Asian Development Bank, the staff representative continued. Although the loans had been agreed on, no disbursement had yet been made because the implementation capacity in Vanuatu was limited and a shortage of technical experts and local highly skilled manpower was hampering the planning of a project in the agricultural sector.

Concerning education, the staff representative recalled that the World Bank had followed up the indications in the staff report for the 1983 Article IV consultation, of scope for rationalizing the staffing requirement. Although high priority should be given to education, an excessively large share of government expenditure was allocated to it. The World Bank had sent a mission to Vanuatu in March 1984, and was currently preparing a report. A discussion of education and of progress made in the system would certainly be incorporated into the report on recent economic developments prepared in connection with the 1985 Article IV consultation.

Mr. Prowse said that he concurred with Mr. Robinson that Vanuatu's problems were primarily ones of development rather than of adjustment, and included shortages of skilled labor and the need for education.

Expenditures on the latter would be particularly affected by the scheduled decline in recurrent grant assistance from former colonial powers. As noted by the staff representative from the Asian Department, the rationalization of education might become essential, since the dual educational structure in Vanuatu, with its two separate languages, was clearly inefficient, despite certain attractions. The intention of the staff to examine the issue in depth in the next report on recent economic developments would certainly be welcomed by the authorities. It was notable that, although priority had been given to the employment of the indigenous population where possible, the process of indigenization had not been followed to an extreme, as in some other countries. Foreign experts continued to be welcomed into skilled and professional positions, in the realization that they were critical to successful economic development. To raise the technical skills of the labor force, the authorities had set up a national advisory manpower group to evaluate the economy's overall manpower requirements. Clearly they had not overlooked the need for educational and labor developments.

The authorities had made marked progress in dealing with the problem of land tenure, as recorded in a somewhat concise form on pages 8 and 9 in the report on recent economic developments, Mr. Prowse noted. Foreigners who had held land at the time of independence had lost ownership of that land, but now held a lease, the duration of which would depend on the nature of the use to which the land was put, but would usually be for 50 years, although leases for agricultural land would be for 30 years. In addition, a land lease act had been passed in 1983, coming into force in early 1984, which had provided a clear legal framework for the administrative procedure to establish and maintain the registration of leasehold titles and other interests, including subleases and mortgages. Clearly, the authorities had taken a highly pragmatic approach to the issue of land tenure, and had recognized the need to allow expatriate participation.

Commenting on the proposed means of raising revenue in Vanuatu, Mr. Prowse recalled that, during the 1983 Article IV consultation with Vanuatu, the Board had accepted the view that the most efficient means of raising revenue in the short term would be an increase in consumption tax on imports, while a sales tax on domestic production was to be the objective in the medium term. An income tax had not been seen as feasible in the near future for reasons explained by the staff representative from the Asian Department. Nothing had changed since 1983, except that the authorities would not, in principle, oppose any form of tax which appeared to be efficient and flexible.

Referring to Vanuatu's exchange rate policy, Mr. Prowse noted that it was unusual for an economy to be able to revalue its currency without harming its external account. Exports in 1983 had grown by 73 percent, indicating that there was capacity for upward flexibility in the exchange rate as long as other objectives could also be attained. In fact, the authorities professed a policy of flexibility of the exchange rate in both directions, and he agreed with them that there were no net adverse effects on the balance of payments in the medium term as a result of the recent devaluation. In evaluating the policy, the secondary effects of low inflation and a strong domestic currency should be considered, in addition to the impact on the relative prices of exported and imported goods. Moreover, it was important that the Fund should not create the impression that continuous exchange rate depreciation would be an appropriate policy objective for the Vanuatu authorities, or indeed for the authorities of other small countries. The correct policy stance was to review periodically the relative positions of the external accounts and domestic internal economy, and to weigh the advantages and disadvantages of depreciation for both. The wisdom of that approach should be instilled in the thinking of the Vanuatu authorities.

The Chairman made the following summing up:

> Executive Directors agreed with the main elements of the staff appraisal of the report for the 1984 Article IV consultation with Vanuatu. In spite of structural constraints and vulnerability due to Vanuatu's heavy dependence on one commodity, Directors noted with satisfaction that, in recent years, economic activity had continued to expand with relative price stability and a strong balance of payments. The satisfactory performance of the economy was mainly attributable to the authorities' efforts to implement prudent fiscal and exchange rate policies.
>
> Directors noted that Vanuatu faces some difficult economic problems; in particular, it has to adjust to the decline in foreign grants. The burden of that adjustment will continue to fall largely on the public sector; further efforts to streamline expenditure and to raise new revenue are essential. In this context, some Directors encouraged the authorities to rationalize staffing requirements and contain salary increases in the government sector, and to find sources of additional revenue. Broadening the tax base and raising public utility charges will be particularly important.
>
> Directors also stressed that the Central Bank will have to assume progressively greater responsibility in the conduct of monetary and credit policy. Directors emphasized that the authorities should continue to keep its exchange rate arrangements under close review, and to be flexible in their use of exchange rate policy, if necessary, for the purposes of external adjustment.
>
> It is expected that the next Article IV consultation with Vanuatu will take place on an 18-month cycle.

5. RATE OF CHARGE UNDER RULE I-6(4) FOR FINANCIAL YEAR 1985 - AMENDED PARAGRAPH (b)

The Executive Directors considered a proposal by the staff, based on a correction of net income for FY 1984, to amend paragraph (b) of the decision taken at EBM/84/85 on June 1, 1984, to provide that SDR 22 million, rather than SDR 20 million of a net income in excess of the target amount for the 1984 financial year, be deemed as income for the 1985 financial year (EBS/84/91, Sup. 3, 6/22/84).

Mr Prowse said that, having considered Supplement 3 to EBS/84/91, he could see no reason for not accepting the proposed decision.

Mr. Malhotra, Mr. Hirao, Ms. Bush, Mr. Robinson, and Mr. Senior also accepted the proposed decision.

Mr. Shaw said that he supported the decision, which was consistent with the extensive discussion on the same issue that had taken place at EBM/84/85.

The Executive Directors reaffirmed the decision to place net income for FY 1984 to the Special Reserve and took the following decision:

> Paragraph (b) of Executive Board Decision No. 7713-(84/85) is amended to provide that SDR 22 million, instead of SDR 20 million, of the net income in excess of the target amount for the 1984 financial year shall be deemed as income for the 1985 financial year.

Decision No. 7740-(84/100), adopted
June 27, 1984

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/99 (6/22/84) and EBM/84/100 (6/27/84).

6. COSTA RICA - 1984 ARTICLE IV CONSULTATION - POSTPONEMENT

> Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for concluding the 1984 Article IV consultation with Costa Rica to not later than the end of July 1984. (EBS/84/138, 6/22/84)

Decision No. 7744-(84/100), adopted
June 26, 1984

7. DOMINICAN REPUBLIC - 1984 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance Over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for concluding the 1984 Article IV consultation with the Dominican Republic to not later than August 10, 1984. (EBD/84/175, 6/22/84)

Decision No. 7745-(84/100), adopted
June 26, 1984

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and an Advisor to an Executive Director as set forth in EBAP/84/134 (6/21/84) and EBAP/84/135 (6/25/84) is approved.

APPROVED: February 6, 1985

LEO VAN HOUTVEN
Secretary