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04

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/125

3:00 p.m., August 8, 1984

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. Koné, Temporary
	S. Kolb, Temporary
	G. E. L. Nguyen, Temporary
A. Donoso	
	M. K. Bush
	M. Lundsager, Temporary
	N. U. Haque, Temporary
H. Fujino	
	J. Reddy, Temporary
R. K. Joyce	
A. Kafka	
	G. Grosche
	G. Gomel, Temporary
	A. Vasudevan, Temporary
	S. El-Khouri, Temporary
	A. Steinberg, Temporary
	K. G. Morrell
	A. A. Agah, Temporary
	S. M. Hassan, Temporary
	J. E. Rodriguez, Temporary
	E. Olsen, Temporary
	T. A. Clark
	J. Bulloch, Temporary
	Wang E.

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

Also Present

Asian Department: S. Kohsaka, J. Schulz, B. J. Smith, J. Thornton. European Department: L. L. Pérez. Exchange and Trade Relations Department: M. Guitián, Deputy Director; E. H. Brau, M. O. Tyler. Fiscal Affairs Department: P. S. Griffith. Legal Department: J. K. Oh, S. A. Silard. Western Hemisphere Department: S. T. Beza, Associate Director; E. Decarli, J. E. Gonzalez, D. N. Lachman, J. P. Pujol. Advisors to Executive Directors: H. A. Arias, H.-S. Lee, W. Moerke, D. I. S. Shaw. Assistants to Executive Directors: R. L. Bernardo, H. Kobayashi.

1. PAPUA NEW GUINEA - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Papua New Guinea (SM/84/174, 7/18/84). They also had before them a report on recent economic developments in Papua New Guinea (SM/84/182, 7/25/84).

Mr. Morrell made the following statement:

Papua New Guinea is an island economy in the early stages of economic development. It is endowed with considerable natural resources but hampered by some of the most difficult terrain in the world. It relies for its export income in a few raw materials and primary products, and is therefore vulnerable to fluctuations in world commodity and mineral prices.

Since 1982, the Papua New Guinea authorities have been undertaking a series of strong adjustment measures in order to halt the deterioration in the balance of payments and in the domestic budgetary situation which resulted in part from higher oil prices, declining commodity prices, and a downward reassessment of the ore content of the Bougainville copper mine.

During 1983, there was a moderate recovery in economic growth to 2 percent and a substantial improvement in the balance of payments. This improvement is continuing. Although there is still a balance of payments deficit on current account, there are also substantial capital inflows associated primarily with the Ok Tedi project.

My authorities are in broad agreement with the staff's assessment of economic developments in Papua New Guinea, but do have some reservations about the staff's views on the operation of monetary policy.

While the staff sees the Papua New Guinea economy recovering at a fairly rapid rate over the rest of 1984 and into 1985, resulting in a sharp increase in import demand financed by rapid monetary growth, the authorities are not so confident of the duration or strength of the recovery, and consider that the current stance of monetary policy is appropriate. They point out that a significant part of new lending by banks reflects refinancing of offshore borrowing rather than expanding activities in Papua New Guinea.

The authorities see the economy as still quite depressed and believe that a relatively strong effort should be made to encourage private sector borrowing. Although they concede that the money supply did rise sharply in 1983 and that another fairly strong increase is projected for 1984, they note that

this rapid increase follows several years of slow growth. In their view, business firms and individuals are simply recovering lost ground in rebuilding their deposit and current balances.

The authorities are conscious of the significant advances made in macroeconomic policy over the past 12 months and are anxious that these gains not be dissipated. Developments in the economy are being closely monitored, and the authorities are prepared to take restrictive actions should there be a sharp rise in import demand. So far there is no sign that any surge in imports is developing.

In one measure on the monetary side, effective August 1, the authorities have raised the minimum liquid assets ratio of the commercial banks by 2 percentage points to 16 percent, in order to reduce the high level of excess liquid assets held by the banks. Further similar adjustments may be made in coming months.

Public sector expenditures declined by 1 percent in real terms in 1983 as a result of civil service retrenchments and delayed implementation of capital works projects. The authorities are continuing to maintain firm control of fiscal expenditure and will take advantage of larger than forecast external receipts to reduce the need for external borrowing.

While the staff appraisal points out that Papua New Guinea has in recent years borrowed heavily abroad, with a considerable increase in the debt burden, it is important to put this borrowing in its proper perspective. Papua New Guinea's debt service ratio is below that for many developed economies, and well below that for most developing countries. Furthermore, the current progress toward reducing to zero the country's net overseas borrowing, in order to preserve access to borrowing for times when the terms of trade are not so favorable, should be recognized.

Wage determination has been a key factor influencing economic conditions in Papua New Guinea. Minimum wages are determined by the Minimum Wages Board (MWB), an independent tribunal consisting of representatives of the Government, employers, employees, and the community. The present agreement, which has also been accepted by the public service workers, provides for indexation only up to 5 percent per annum. My authorities regard the successful renegotiation of the wage accord at the end of 1985 as crucial to future development.

Regarding the balance of payments, forecasts are currently being reworked, with short-term prospects appearing even more favorable than when the mission team held its discussions, a reflection of a more bouyant export outlook. Average prices for most agricultural exports are now projected to be higher than

previously thought, while the more pessimistic outlook for gold and copper prices has been partly offset by favorable exchange rate movements. The coming on stream of the first stage of the Ok Tedi project will also contribute positively to export receipts.

The medium-term development strategy planning and policy development process is now in full swing, and officials are confident that a consistent and detailed strategy will be in place before the 1986 budget. Finally, my authorities have asked me to mention their desire to receive some technical assistance in statistical collection. I understand that this matter is currently under consideration in the Fund.

Miss Bulloch observed that recent favorable developments in the Papua New Guinea economy, in particular the strengthening of real GDP growth and the turnaround in the overall balance of payments position, owed much to the adjustment measures implemented progressively over the past few years, including courageous fiscal actions. However, the economy remained vulnerable to external developments, especially fluctuations in the prices of major exports, including copper. Therefore, policies needed to be designed to build up the economy's resilience to the impact of possible adverse external developments.

The expenditure savings and tax increases introduced by the authorities in recent years had improved the fiscal position, excluding official transfers, by nearly 3 percentage points of GDP, Miss Bulloch continued. However, she agreed with the staff that pressure on budgetary expenditure might be heightened during the current year and beyond. It was therefore appropriate for the authorities to pursue a cautious budgetary strategy. The discretionary tax measures introduced in the 1984 budget were a commendable attempt to boost revenue without damaging business confidence. It would be consistent with the authorities' policy aims if slightly more emphasis were placed on measures to broaden the tax base. It was therefore heartening to learn that the authorities were examining the possibility of extending indirect taxation to cover basic consumer goods.

The wage problem was well illustrated in Chart 3 of the report on recent economic developments, Miss Bulloch remarked. Urban wages were almost three times rural wages, and there was inevitably a drift of population toward the towns. To contain that drift and improve overall employment prospects, it would be necessary to control real wages, as the authorities recognized. Their objective of reducing real wages by about 10 percent over three years would not go far enough to redress the existing wage imbalance fully, although it would represent significant progress in the right direction.

The extension of the wage agreement reached in 1983 to employees in the public sector was welcome, Miss Bulloch continued. The key element of the agreement, in contrast with earlier ones, was that it did not

provide for automatic cost of living adjustments beyond the first 5 percent of consumer price increases. However, the authorities expected consumer price inflation to be about 9 percent for 1984 as a whole, and any pressure on the wage agreement could consequently filter through to affect the competitiveness of exports. The authorities would therefore have to react quickly, if excess demand emerged, by tightening domestic policies.

The limitation of wage indexation had permitted exchange rate policy to play a more active role in promoting Papua New Guinea's international competitiveness, Miss Bulloch added. She hoped that the flexible implementation of exchange rate policy over the past year would continue into the future.

The authorities' generally cautious approach to external policy was appropriate in view of the fragility of the economy's external position, Miss Bulloch went on. The external debt burden seemed manageable, despite the substantial increase over recent years associated in particular with the Ok Tedi project. It was commendable that reliance on commercial balance of payments financing had been avoided. In the long run, a major diversification of the export base would offer the best prospect for balance of payments stability. The task would be a continuing and difficult one that of necessity would involve heavy capital expenditure, underlining the need for adequate control of current expenditure. In that connection, she welcomed the introduction of a National Development Plan covering the years from 1986 to 1990, one objective of which was to improve the efficiency of public investment. The process of diversification might also benefit from the complete liberalization of policies on inward direct investment. She had been glad to learn that the authorities had such a step under consideration, and further information about their plans in that respect would be helpful.

Mr. Fujino noted that the economy of Papua New Guinea had been prudently managed in general since 1980, when the country had experienced a sharp deterioration in the terms of trade. Fiscal deficits had been reduced steadily, for the most part through tight expenditure control, and the overall balance of payments had moved into strong surplus in the latter half of 1983. Important initial steps had been taken toward dealing with the structural imbalances in the labor market in the shape of the decision to limit wage indexation. Some positive signs of recovery had emerged in recent months, and the staff had described the various achievements and structural weaknesses facing the economy.

He fully endorsed the authorities' view that government spending must be kept within the limits dictated by the medium-term availability of budgetary and external resources, Mr. Fujino continued. The staff report indicated that revenue prospects were clouded by uncertainties surrounding copper prices and external aid. The maintenance of the present cautious fiscal policy was therefore warranted. In that respect, he welcomed the authorities' decision to reduce foreign commercial borrowing substantially in response to the stronger than expected revenue performance and lower

than expected budgetary expenditure in the first quarter of 1984. Basically, it should be possible to cover the budget deficit by concessionary borrowing and project-related borrowing from international agencies, so that public sector commercial borrowing could be kept to a minimum. Thus, the authorities' intention to eliminate new commercial borrowing by 1987 at the latest was commendable.

Credit policy had been relaxed considerably since the latter half of 1983 in order to encourage economic recovery, Mr. Fujino continued. In addition to the increase in monetary growth resulting from the balance of payments surplus, the Central Bank had reduced its own interest rates, raised the ceiling on lending by commercial banks, and suspended the lending guidelines. As a result, monetary growth was expected to exceed substantially the original estimate of 10-15 percent in 1984. While some relaxation in monetary conditions might be helpful in promoting economic recovery, the present extremely liberal stance ran the risk of generating excess demand, as the staff had warned. The authorities believed that a tightening of policy would adversely affect the business investment climate; he suggested that effective control of inflation was also a major factor in improving business confidence and inducing foreign direct investment. He had been pleased to note from Mr. Morrell's statement that the minimum liquid asset ratio had recently been raised and that the authorities would closely monitor economic developments and stand ready to take further restrictive steps as necessary.

The limitation of wage indexation to the first 5 percent of consumer price increases in each year, and the extension of the wage agreement to public sector workers, had been pathbreaking events, Mr. Fujino considered. The authorities had taken significant initial steps toward tackling structural urban unemployment associated with high real wages. It was also important that the partial wage indexation agreement had broken the direct link between the exchange rate, domestic prices, and wages; the effectiveness of exchange rate policy as an instrument for improving international competitiveness had undoubtedly been enhanced as a result. The authorities had taken full advantage of the opportunity to allow the kina to depreciate vis-à-vis the Australian dollar over the past year. Exchange rate policy should continue to be implemented flexibly in the future. If employment opportunities were to be increased and exports diversified, further relative price adjustments would be necessary; for that purpose, exchange rate policy was one of the most effective instruments at hand.

Mr. Reddy noted that Papua New Guinea's primary problem was one of development. Even with a per capita income of SDR 723, the country had been described by the staff as one of the least developed countries, a description with which he tended to agree. Happily, the World Bank and the Asian Development Bank were active in various sectors of the economy, including agriculture, transport, telecommunications, power, and, most important of all, education and manpower development. If the absorptive capacity of the economy were to be increased, and the present excessive reliance on foreign expertise reduced, education and manpower training would be vitally important.

A successful fiscal adjustment had been made in 1982 and 1983, Mr. Reddy continued, and he endorsed the authorities' view that fiscal restraint would have to continue for some time. He also strongly supported the view that the share of expenditure on development programs would have to be increased in order to promote growth and job creation. One of the key determinants of the fiscal outcome was incomes policy, and much would depend on its future evolution. The present stance of fiscal policy in Papua New Guinea was appropriate, and he urged the authorities to strengthen their fiscal position further to counter possible adverse external developments.

He shared the staff's concern about monetary policy, Mr. Reddy remarked. More specifically, it was inappropriate for the authorities to ease credit conditions at a time when substantial liquidity was being injected into the banking system from the external sector. He had been pleased to learn from Mr. Morrell's statement that measures had recently been taken to siphon excess liquidity from the banking system.

Real rates of interest, not only on deposits but also on most bank lending, had become negative in 1984 as inflation had increased to over 10 percent, Mr. Reddy mentioned. For a country that was short of savings and that on average financed about half its annual investment from foreign savings, it was important to maintain positive real rates of interest so as to mobilize greater domestic resources and encourage more efficient use of available resources.

In view of the high rate of unemployment and the need to create new jobs, Mr. Reddy went on, the authorities should take bold measures to reduce real wages. The decision to move from full to partial indexation had been an initial step in that direction, and he hoped that further progress would be made. Since the benefits of indexation were confined to the urban organized sector of the economy, incomes policy could have a major impact on the distribution of income, especially during periods of sharp swings in the terms of trade. It would be useful if the staff could comment on the impact of indexation on income distribution during the past several years, giving some indication of the proportion of the labor force that was not directly affected by the indexation mechanism.

External indebtedness and debt service obligations were not excessive at present, and commercial banks were more than willing to lend to Papua New Guinea, Mr. Reddy noted. Nonetheless, the authorities should take care not to rely excessively on external borrowing. External debt had increased rapidly in recent years, and the trend could not be sustained for long. Therefore, he welcomed the decision by the authorities to eliminate commercial borrowing by the public sector in 1987. Like Mr. Fujino, he would encourage them to make greater use of concessional sources of finance, and at the same time to provide greater incentives for the mobilization of domestic resources.

As one of the least developed countries, Papua New Guinea had a crucial need for foreign assistance in its development process, Mr. Reddy commented. Grant aid accounted for over 20 percent of current account

receipts, was equivalent to 11 percent of GDP, and financed about one third of central government expenditures. In the circumstances, any abrupt reduction in foreign aid from Australia could have serious repercussions, and he hoped that the level and quality of that aid could be maintained in future.

There was a short analysis of nonfinancial public enterprises in the report on recent economic developments based on data from five of those enterprises, Mr. Reddy said. He hoped that, in the next Article IV consultation report, coverage of the operations and the financial position of state enterprises would be fuller. Finally, was there a mechanism in place in Papua New Guinea to monitor all nonfinancial enterprises?

Ms. Lundsager remarked that following a three-year recession, real economic growth had resumed in 1983, owing to more favorable external conditions and the fruition of effective adjustment policies. Key export prices and volumes had increased, while imports had remained low, leading to a substantial improvement in the terms of trade and the current account deficit.

In several areas, economic policies had led to needed domestic adjustments, Ms. Lundsager observed. As in 1982, budgetary policy had remained restrictive and had included a 10 percent reduction in civil service positions. The adoption of an agreement on wage indexation would not only reduce the disparity between real wages and productivity, with a favorable impact on employment, but would also permit the use of a more flexible exchange rate policy. The international competitiveness of exports would improve as a result, and the balance of payments position would be strengthened.

She supported the authorities' efforts, through their industrial strategy, to provide incentives for private sector development, Ms. Lundsager went on, and she noted their adoption of a business revival package for that purpose. The promotion of greater competition in the financial markets through the liberalization of interest rate controls and the establishment of new commercial banks was also welcome. Finally, she recognized the significant role of foreign direct investments in the mining sector and encouraged the authorities to implement their plans to further liberalize foreign direct investment in other sectors of the economy.

As to the outlook for Papua New Guinea, the medium-term policies adopted took appropriate account of less favorable external conditions, particularly with respect to commodity prices and foreign concessional assistance, Ms. Lundsager observed. The authorities should maintain budgetary control, in spite of the present favorable economic climate, and concentrate on adopting a complementary policy that would promote a sustainable growth in demand. Papua New Guinea was appropriately concerned about foreign perceptions of its debt situation and its investment climate, and she welcomed the authorities' plans to reduce commercial borrowing to alleviate the presently increasing debt servicing burden.

Mention was made in the report on recent economic developments of the authorities' general development strategy, designed to increase employment, Ms. Lundsager remarked. However, the staff report stated that opportunities for government action leading to the attainment of development objectives were likely to evolve slowly. In light of the structural weaknesses of Papua New Guinea, often characterized as one of the least developed countries, she would be glad to have some indication of how that goal of increasing employment could be meshed with the need for basic human and infrastructure development. She had noted the involvement of the World Bank in agriculture and in other sectors, but would be interested in learning the extent of World Bank assistance in formulating an overall development strategy, especially as it related to the multiyear National Development Plan mentioned in the staff report.

The staff representative from the Asian Department said that since independence, the authorities' policies had been guided by the wish to reduce the country's previously heavy dependence on foreign entrepreneurial activity in all sectors. Foreign investment, without ever having been banned except in a few areas, had been discouraged in some sectors and was generally subject to approval. Regulations required approval for any investment in which foreigners held more than 26 percent of the equity, and approval was not always given for investments in subsectors where indigenous entrepreneurs had the capacity to serve. However, as the true dimensions of the employment problem had become apparent, and because indigenous enterprises had not developed as expected, the authorities had recognized the need to liberalize foreign investment policies to contribute to employment. Government policy was evolving in the direction of simplifying approval procedures and ensuring that they were narrowly focused on foreign investment considerations rather than on more general considerations; delays should be minimized in the future. In the large-scale natural resource-based industries that were costly to operate, such as the Bougainville and Ok Tedi mining projects, the capacity for development and financing was not available locally, and the authorities continued to look to foreign investment for their development, even though the direct impact in generating employment was small.

A country like Papua New Guinea had no reliable information on income distribution, the staff representative explained. However, it was clear that an income distribution problem had emerged and had been exacerbated by the recession in 1980-82. The employed had of course been favored over the unemployed, whose number had probably doubled in the past ten years. The urban unemployed had been extremely hard hit, but the rural community at large had suffered in the past three years from the adverse movement in the terms of trade. More recently, the numbers of the urban unemployed had been swollen by the 10 percent of public servants who had been retrenched, in addition to unemployment arising from the stagnant private sector. The limited wage indexation arrangement put in place had been designed to have a positive impact on income distribution. Combined with the recent recovery in the terms of trade--albeit only a partial one--there was hope that the employment base would become more broadly based in time and that there would be less of a disparity between the few

with wage-earning jobs and the many without them. However, the wage indexation agreement would apply only to the roughly 15 percent of the labor force that was formally employed; the vast bulk of the population depended for its livelihood on village society, and often existed only on the fringes of the cash economy.

Papua New Guinea had benefited over the years from technical assistance by the Fiscal Affairs Department on the management of nonfinancial enterprises, the staff representative noted. There had been no difference of view between the authorities and the staff on how those enterprises should be managed or their finances monitored. The Fund's assistance had been related to technique rather than policy determination. As the Finance Minister's budget speech for 1984 had made explicit, the staff report had been accepted, and its recommendations were being implemented. Good monitoring procedures were in place, and, with perhaps one exception, the public enterprises were being run quite profitably and on commercial lines.

The World Bank had been involved in discussions on the formulation of development planning in Papua New Guinea, the staff representative commented. The authorities had been looking to the advice of the World Bank, which had identified for them the problems inherent in the previous development planning strategy, whose short-term nature had not ensured consistency among the various sectors covered. It was not yet clear what support the World Bank would give to the process of developing the new planning strategy, which was just being started.

Mr. Morrell noted that Papua New Guinea was rich in resources, yet its terrain presented it with many difficulties that were at the root of some of the urban unemployment. There were surely few countries whose capital city was not linked by roads or rail to any other major population center, so that people attracted to the city by the hope of employment were unable to return home or move on because of the difficulty and expense of transport. Under the social system in Papua New Guinea, those people generally were supported by others with employment, which created a serious social problem.

As Executive Directors had noted, Mr. Morrell went on, the authorities had been pursuing a cautious and conservative policy stance for a number of years. The result had been a strengthening of the budgetary position, and an external position that had improved so much that Papua New Guinea was among the few developing countries judged to have a reserve position sufficiently strong for it to be included in the Fund's operational budget. The authorities were understandably trying to encourage growth to provide greater employment opportunities; they were aware of the danger of overstimulation of the economy, particularly from the monetary side, and they stood ready to take any further actions necessary to offset adverse developments.

The reduction in real wages was a significant achievement, Mr. Morrell remarked, although the Government had actually sought an agreement that would have led to a greater reduction in real wages and had introduced a

differentiation between urban and rural wages. The first agreement had stemmed from a decision of an independent tribunal, of which the Government formed only one part; the authorities looked forward to the renegotiation of the agreement, late in 1985, but they wished to respect the framework for negotiating wage agreements, which were an important part of the democratic process.

Diversification was difficult in a country with large and concentrated natural resources that required so much capital to develop, Mr. Morrell commented. The Government had therefore placed constraints on its overseas borrowing to finance development of those resources, as well as to attract funds to develop other resources, especially as it had been borrowing heavily for existing projects. It was probably unrealistic to expect any country in the region to have a completely liberal policy on foreign investment. Moreover, because of its external debt position, Papua New Guinea would no doubt wish to retain some control on the size of projects and on the likely consequences of borrowing overseas.

The Acting Chairman made the following summing up:

Executive Directors noted that the economic position of Papua New Guinea had improved considerably in 1983 as the recession came to an end and the balance of payments moved into surplus. The improvement was due in part to the strengthening of export demand and a favorable shift in the terms of trade, and also reflected the successful implementation of adjustment measures over the past two years. Directors noted the important role played by the strengthened fiscal policy in this adjustment effort. They commended in particular the authorities' firm control on government spending, especially in containing the public wage bill.

While the outlook for the current year was for a further external surplus and a strengthening of economic growth, Directors cautioned against easing demand restraint in view of the likelihood that the recent buoyancy in the terms of trade could prove to be short-lived. The 1984 budget continued the policy of fiscal restraint, which was appropriate under the circumstances. Directors stressed the importance to the successful implementation of budget policy in 1984 of maintaining tight control over government spending. It was also emphasized that broadening the tax base would be an important part of fiscal policy. Monetary growth had risen sharply over the past year with the strengthening of the external account. The relaxed credit policy introduced in 1983 was being maintained during the current year. Directors viewed those developments with some concern, and indicated that monetary growth should be reduced from the high recent and prospective rates. To this end, it was suggested that credit policy should be tightened beyond the measure recently taken to absorb banks' liquidity and that anticyclical policies be strengthened to counter potential external and price pressures. Directors

noted that most interest rates were negative and encouraged the authorities to permit positive real interest rates, not only in response to current liquidity considerations, but also to encourage savings over time.

Directors believed that measures designed to overcome structural imbalances would be necessary if the authorities were to be successful in their medium-term objectives of promoting economic diversification and of increasing growth and employment opportunities, while maintaining a viable balance of payments position. Steps taken recently, including those to rationalize development planning procedures and to realign wages with underlying productivity trends by limiting wage indexation, represented useful progress in that direction. The authorities also were commended for their management of the exchange rate over the past year, and were encouraged to continue to take advantage of the greater flexibility that was afforded to exchange rate policy by limited wage indexation, subject of course to the need to contain inflation within acceptable limits.

Directors observed that external debt and the cost of debt servicing had risen sharply in recent years. Thus, Directors welcomed the authorities' decision to sharply reduce government commercial foreign borrowing in the current year. The need to reduce external borrowing in the future reinforced the need to increase domestic savings and to provide broader opportunities for foreign direct investment. Papua New Guinea's need for concessional foreign assistance was also emphasized by Directors.

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

2. DOMINICAN REPUBLIC - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with the Dominican Republic (SM/84/161, 7/5/84; and Cor. 1, 8/6/84). They also had before them a report on recent economic developments in the Dominican Republic (SM/84/166, 7/19/84).

Mr. Kafka made the following statement:

My Dominican authorities appreciate the staff report for the 1984 Article IV consultation. But, some of its facets require elaboration.

The most dramatic aspect of recent economic history resulted from the international recession and its especially severe impact on sugar, bauxite, gold, and ferronickel, as well as other exports of importance to the Dominican Republic. The value of exports fell by 35 percent in dollar terms; in purchasing power,

exports fell by close to 40 percent. The consequences of this blow included not only the loss of exchange revenue but also a severe erosion of the tax base and of the financial situation of government enterprises, especially the State Sugar Council. All this is well described in the paper, and it is clear that adjustment to these developments--which were entirely outside the control of the Dominican authorities--could not take place immediately.

When in August 1982 the new Administration assumed office, it immediately initiated negotiations for an extended arrangement with the Fund. As the staff mentions, all purchases foreseen for the first year of the program were carried out, and several of the objectives were achieved, but the adjustment was smaller than planned. The staff attributes this discrepancy between fulfillment of the performance criteria and the degree of adjustment to two factors.

The first is the fact that a fiscal imbalance developed only late in the year. It should be noted, however, that, even so, fiscal performance in 1983 was somewhat better than in 1982 in the context of a considerable acceleration of growth and moderate inflation. The former improvement occurred mainly because of the introduction of new revenue measures; they comprise, in particular, a temporary import surcharge and the new general sales tax of the value-added type, which is of particular importance for the long run, because its yield is not directly dependent on the performance of the foreign sector of the economy; as well as improved administration of taxes.

The second cause of the discrepancy the staff attributes to the effect of the rescheduling of debt to commercial banks. This cause requires two comments. First, negotiations with the commercial banks had started toward the end of 1982, i.e., before the authorities signed the letter of intent on January 14, 1983, although the negotiations were not completed until December 1983. The rescheduling affected net international reserves and arrears as well as net domestic assets. Second, the footnote to Table 3 and to Table 4 of the memorandum on the economic policies of the Dominican Republic attached to the letter of intent dated January 14, 1983 (EBS/82/239, Sup. 1, 1/26/83) made it quite clear that refinancing with a maturity of more than five years of letters of credit due to commercial banks would exempt these liabilities from being regarded as part of arrears or reserves liabilities.

It has not been possible to come to a timely agreement between the Fund and the member country on the second year of the extended arrangement. However, close contacts have at all times been maintained with the Dominican Republic, and the differences

which initially emerged not only on the facts but also on the objectives of the adjustment policies for the second year have been progressively narrowed down. In order to understand why this was a long drawn-out process, it must be realized that internal developments as well as the drastic fall in exchange revenue made a major effective devaluation of the Dominican peso unavoidable. In the Dominican Republic, it was clear that this would be a traumatic experience, much more so than in almost any other country. The parity of the Dominican peso to the dollar has been maintained unchanged for 50 years. Gradual adjustment has been going on for several years. At first, it was limited to a tolerated parallel market, which fluctuated between 12 and 15 percent above par. The new Government began exchange adjustment in earnest, through the transfer to the parallel market not only of invisibles but other transactions out of the official market. When in April of this year, in the context of negotiations, a major transfer was made of practically all nonpetroleum imports, the popular reaction was even more violent than had been expected, and almost 60 human lives were lost. As is understandable, this experience has slowed down the further negotiations.

While monetary policy, within the limits set by budget deficits, has always been cautious, the Dominican authorities, nevertheless, are convinced of the need for further action both in the external sector and in the fiscal area, as well as that of public sector corporations. Thus, the recent arrangement by which basic exports receive an exchange rate of RD$1.48 per U.S. dollar, while petroleum imports continue to be made at parity, can obviously be only transitory. Additional tax revenue is needed, moreover, to avoid the need for an excessive cut in investment and permit an increase in interest payments from the Government to the Central Bank, in order to strengthen the financial position of the latter. The authorities have decided to lay the ground for this further action by the careful preparation of what is in effect a social compact to assure acceptance of the necessary sacrifices by all sectors of the population. In the context of these further measures, they expect to carry out their understanding with the Fund in the form of a bridge (or shadow) program to be followed after its termination by a formal stand-by arrangement with resumption of drawings from the Fund as well as further progress to permit the adoption of additional adjustment measures.

The initial steps will consist of the transfer of petroleum imports, except for those of the Dominican Electric Corporation, to an intermediate market with a surcharge of 50 percent in relation to the parity. Thus, only petroleum imports of the Electric Corporation, the service and disbursements on public debt, and the service on existing private debt will continue to be transacted at the par value. The fact that basic exports will

continue to receive a premium of a similar magnitude instead of being transferred to the parallel market will sharply reduce (increase) the exchange loss (profit) to the Central Bank. The Government will also prepare fiscal measures that have been detailed by the staff and will take action with respect to the State Sugar Council and the Dominican Electric Corporation as well as the Price Stabilization Institute to improve efficiency. The exchange premium for basic exports is by itself greatly benefiting the finances of the State Sugar Council. A loan from the World Bank is expected, which will assist the efficiency of the Dominican Electric Corporation and rate adjustments are not excluded. The World Bank assistance is predicated on changes in the adjustment program in line with the Bank's suggestions, which the authorities are now undertaking to implement.

If these plans can be fully realized, prospects for an improvement in the Dominican situation in the last half of this year are favorable. In contrast to most countries that have faced debt difficulties, the Dominian Republic is receiving no financing from commercial banks for interest payments but is merely rolling over the major part of the amortization; therefore, there should be a relatively quicker reduction in the debt service burden than would otherwise be the case. Apparently, expectations are not unfavorable. The recent massive transfer of imports to the parallel market has produced no visible pressure on that market; in fact, the rate in this market is now some 10 percent below the figure recorded earlier this year. Since last January, the Central Government has been able to avoid recourse to credit from the Central Bank, and the public sector's recourse to finance from the Central Bank and the Reserve Bank combined has been considerably below what it was during the same period last year. There are also favorable prospects for export growth. Finally, the Dominican Republic is proceeding with the preparation of structural reforms.

Mr. Steinberg commented that the highlight of the staff report was obviously the progress, or lack of it, under the extended arrangement. Although adjustment had fallen short under the program, the Dominican Republic had observed all performance criteria through September 1983, had made all purchases in the first year of the arrangement, and had then failed to meet the indicative criteria for the final quarter. When the Executive Board had considered the last review under the extended arrangement (EBM/83/121, 8/24/83), one Director had expressed some doubt about the Dominican Republic's need for an arrangement under the extended Fund facility, which had been designed to enable countries to pursue medium-term structural programs of adjustment. The Dominican Republic's need was for medium-term adjustment, mainly in the exchange system and in public sector activities and financing. Yet the country's structural problems seemed to exceed the Government's ability to cope with them. The exchange system was a complicated system of multiple rates and other

currency practices, including various export incentives, with different rates applying to categories of imported goods and services. Further complications arose from the application of different rates of customs duties and sales tax. The resulting problems were magnified by the huge gap between the exchange rates for the peso in the official and the parallel markets.

During the first year of the extended arrangement, Mr. Steinberg continued, the Government had taken several steps in the right direction, as outlined in the staff report. However, in the crucial areas of the exchange system, with its effects on prices, and in government finance and the whole financial structure of the official sector, the steps had been only initial ones. Two major prices--for oil and electricity--were particularly out of line, owing to subsidization. Mr. Kafka had mentioned the authorities' intention to transfer petroleum imports to an intermediate market with a surcharge of 50 percent over parity, but to continue to sell petroleum to the Electricity Corporation at the parity rate, an exception that would leave a major loophole in the system, despite the usefulness of the surcharge.

More generally, Mr. Steinberg remarked, he would urge the authorities to work toward unifying the exchange rate system and to apply the new exchange rate for the purpose of taxing imports. Action in that direction would not only remove some of the worst distortions in the economy, but also help to reduce the government deficit. Strengthening the government budget was another major task of the economic program: revenue equaled only about 9 percent of GDP. The elimination of various exemptions from the general sales tax, as recommended by the staff, would be helpful, as would the elimination of the various forms of subsidy, from the use of a low import valuation base to subsidized prices, particularly the prices charged by public enterprises.

It was not clear to him to what extent the losses incurred by the Central Bank stemmed from exchange rate subsidies, and to what extent they were the result of low interest rates on credit to the public sector, Mr. Steinberg commented. Was the Central Bank forced to lend money at such low rates? In any event, the cost of those two accounts should be borne by the government budget, not financed by eroding the capital of the Central Bank.

The staff had referred in SM/84/161 to a recent World Bank report in which attention had been drawn to various distortions and inefficiencies in the public sector, Mr. Steinberg noted. The World Bank had also recommended that the public sector investment program be scaled down. Like the staff, he urged the authorities to expedite the implementation of the World Bank's recommendations to increase economic efficiency.

Even with the measures announced so far, the wide range of structural changes needed would require major additional measures, Mr. Steinberg concluded. Should the extended arrangement have to be considered, for all practical purposes, beyond repair, his chair would welcome continued

discussions with the Fund aimed at concluding a one-year stand-by arrangement, which would set the Dominican Republic's economy on the road to financial rehabilitation.

Mr. Joyce commented that the current state of the Dominican Republic's economy was of significant concern. Of even greater concern, however, was the authorities' lack of progress in pursuing successful adjustment measures to promote financial stability and correct the serious structural weaknesses in the economy. The situation was all the more regrettable because the extended Fund arrangement entered into in December 1982 by the then-new Administration had offered a demanding but nonetheless promising plan for overcoming the Dominican Republic's immediate balance of payments difficulties and achieving some of the more fundamental structural changes that were clearly required. Although a number of welcome adjustment measures had been implemented during the first three quarters of the first year of the arrangement, they had not been sufficient to deal with the difficulties that the economy faced, and the program had gone off track in the fourth quarter. Yet that failure was not of as much concern as the authorities' inability since then to bring themselves to take measures that would offer hope for a revival of the program and the achievement of its objectives.

The recent positive measures were welcome, Mr. Joyce remarked, including the new base for valuing imports for customs purposes and, more important, the decision to transfer most imports other than petroleum imports to the parallel exchange market. However, he agreed with the staff that those measures in themselves did not adequately address the magnitude of the imbalances in the economy. In the circumstances, the extended arrangement seemed beyond salvaging and should probably be canceled. Mr. Kafka himself appeared to have accepted that judgment because he had referred to the possibility at some time in the future of a formal stand-by arrangement, and of a bridge or shadow program in the interim, the nature of which was unclear. Any suggestion that the authorities were likely to be able to bring the present program back on track in the foreseeable future would be unrealistic. But a shadow program that was simply a recognition of the need for fundamental decisions before a new Fund-supported program could be considered would be acceptable to him.

Admittedly, in pursuing a meaningful adjustment program, the Dominican Republic authorities were confronted by serious political difficulties, which had understandably inhibited them from taking further action and had slowed, if not derailed, negotiations with the Fund, Mr. Joyce went on. Many governments faced the dilemma of being unable to muster popular support or even public tolerance of the measures that they knew had to be taken. Yet inappropriate demand management policies and structural distortions in themselves were contributing to social strains in the Dominican Republic. Failure to carry out an adequate and timely adjustment program would only result in a further deterioration in the economy and increased social pressures. Ultimately, the needed adjustments would take place, with or without Fund assistance. The disruptive impact of the process would only be increased by further delays in proceeding with

a rational adjustment program, whether or not it commanded the Fund's backing. He therefore urged the authorities to try to develop a national consensus that would permit them to plan a new adjustment program, one that might be more acceptable domestically and that might in turn form the basis for a new Fund program at an early date.

Efforts to remove structural distortions would have to be central to any new adjustment program, Mr. Joyce considered. The phased removal of the multiple exchange rate system would be a key element of such a program. Notwithstanding the financial boost to traditional exports, the grossly overvalued official exchange rate had imposed a serious constraint on profitability; such exports accounted for close to 60 percent of total export revenues, and the current practice was seriously limiting foreign exchange earnings. Complementary measures would have to be taken on the import side. The transfer of most imports out of the official market had been a major move, although it would be essential for the authorities to go further and take out oil imports, currently accounting for 35 percent of the import bill. He therefore welcomed Mr. Kafka's confirmation that oil imports were to be transferred out of the official market and transacted, at least initially, on the basis of a new intermediate exchange rate. It was also vitally important that the authorities reduce as quickly as possible their outstanding external arrears, thereby contributing to the restoration of the Dominican Republic's international creditworthiness.

There would also have to be much greater improvement in monetary and fiscal policy, Mr. Joyce continued. A successful monetary policy would depend in part on fiscal performance, since there was clearly no room for any new central bank credit to the public sector. A more flexible interest rate policy was called for to ensure that capital was allocated more effectively, to discourage capital outflows, and to foster domestic savings. As the staff had said, quick action was needed to make interest rates on credit to the public sector adequate, and to introduce lower minimum denominations of the high-yield financial certificates.

Fiscal policy would also have to be tightened if the price effects of the adjustments in the exchange rate were not to lead to increased inflationary pressures, Mr. Joyce noted. Further action on both the revenue and the expenditure fronts would be required. The measures taken to expand the tax base and to increase its flexibility had been bearing fruit. The strong growth in revenues in 1983 had been encouraging, and he hoped that it would be duplicated in 1984. The Government should continue its work in enhancing revenue, and should also broaden the application of the sales tax, as suggested in the staff report. In reforming the tax system, however, activity in the more productive sectors of the economy should not be needlessly restricted.

Constraining the growth in public sector expenditures would also call for a continuing effort, Mr. Joyce said. Control over central government outlays appeared to be weak: they had risen from 12.7 percent of GDP in 1982 to 13.1 percent in 1983. Expenditure control was an even more pressing requirement for the state enterprises. Some progress had been

made over the years in reducing the Central Government's deficit as a proportion of GDP, but most of the hard-won gains had been lost by the deteriorating position of state enterprises. As noted in the staff report, the deficit of those enterprises as a proportion of GDP had been 2.9 percent in 1983, compared with a mere 0.2 percent in 1979. He therefore supported the World Bank staff's recommendation that the public investment program of the Central Government and state enterprises should be scaled down substantially. The authorities should also be encouraged to insist on prompt increases in the prices charged by state enterprises, so that they could stand more firmly on their own feet. The increases in sugar and cement prices had been at least a first step in that direction.

He appreciated that a difficult task lay ahead for the Dominican Republic authorities, Mr. Joyce remarked. Fortunately, as Mr. Kafka had noted, there were some signs of favorable prospects for export growth, and the authorities were proceeding with the preparation of structural reforms. They appeared to have been seized with the seriousness of the country's present circumstances and to be desirous of improving them, but they had little time left, especially if the Government planned to seek a further restructuring of its debt in the coming years. He hoped that the authorities would continue to hold discussions with the Fund and soon be in a position to negotiate a new program supported by an arrangement.

Miss Bush said that she concurred with the staff appraisal. It was clear that policy initiatives were needed in two basic areas of concern, namely, to contain aggregate demand and to achieve a structural adjustment of the economy through a realignment of relative prices. The appropriate policies were a mixture of fiscal, monetary, exchange rate, and supply-side policies, several of which would address more than one problem. In particular, the channeling of more imports through the parallel market should help to reduce demand for previously underpriced imports and should stimulate the domestic production of import substitutes. The parallel market should be expanded to cover all imports, including all energy products, thereby improving the external payments position, raising the cost of imports to their real economic value, and inducing a more rational use of limited resources. However, flexible exchange rate management would not be sufficient to contain the demand for imports, given the high rate of consumption, which would have to be dealt with by a combination of monetary and fiscal policies. In particular, the government budget needed to be brought under control. She had noted the World Bank's view that the current public investment program was too ambitious and that capital expenditures could be reduced without sacrificing the development of the country.

Savings were feasible in several areas of current expenditure, Miss Bush considered, including the Government's wage bill. The most significant savings in the public sector could be generated in the state enterprises, which were currently operating at unsustainable losses carried either directly in the fiscal budget or indirectly in the central bank budget. Not only were those operating losses a significant drain on public sector resources, but the inappropriate structure of prices encouraged the inefficient production and consumption of regulated products.

As to the monetary sector, Miss Bush mentioned, there was an urgent need for rapid completion of the study on interest rates. Adequate domestic savings were being hindered by inappropriately low interest rates, which would have to be made significantly positive in real terms, especially on smaller saving accounts, to provide an incentive for reduced consumption and to reward savers.

From a broader vantage point, it was regrettable that the Dominican Republic authorities had been unable to reach agreement with the Fund on a new program under a stand-by arrangement to replace the extended arrangement. Additional adjustment measures were required to contain and then to reverse the deterioration in the external account. Under the first year of the extended arrangement and during the first half of 1984, the authorities had taken several policy measures designed to improve economic conditions. Incentives for traditional and nontraditional exports had been increased, and new fiscal revenue measures had been introduced. Of particular importance had been the transfer earlier in 1984 of imports of most goods and services to the parallel market. While noting those measures, she regretted that the adjustment effort had fallen short in some ways of what was necessary to reach agreement with the Fund on a comprehensive adjustment program and stand-by arrangement. However, she was pleased to learn that the authorities were continuing to work closely with the Fund staff, the aim being to introduce an adjustment program that could eventually warrant Fund support.

Reference had been made by Mr. Kafka to a bridge or shadow program, Miss Bush observed. Again, coordination with the staff on putting in place additional adjustment measures should enhance efforts to arrive at a comprehensive adjustment program. However, a shadow program could not in any way substitute for the comprehensive program necessary before management could recommend a stand-by arrangement to the Executive Board.

In conclusion, noting the adjustment efforts made so far, Miss Bush stated that she encouraged the authorities to pursue those efforts, which were the most crucial ingredient for sustained economic viability and growth, and to continue their close coordination with the staff in doing so. She looked forward to a comprehensive adjustment program being implemented that would justify management's recommendation to the Board of a stand-by arrangement.

Mr. Grosche noted that the process of adjustment in the Dominican Republic had subjected not only the country but the Fund as well to a great deal of strain. He broadly agreed with the staff appraisal and with the approach chosen by the staff in dealing with the Dominican Republic's problems. The Fund had been blamed for much of the popular reaction to austerity measures taken by the authorities to deal with their current problems, which he stressed were not the result of the Fund's advice. The Fund was not responsible for members' internal and external imbalances, and the key to the success or failure of an adjustment program was whether or not the government concerned implemented the

appropriate policies, irrespective of whether or not the Fund had advised their adoption. Experience had shown, however, that Fund advice, and not only Fund money, could be crucial in helping a member to overcome imbalances.

The recent round of discussions between the staff and the Dominican Republic authorities had extended over seven months, Mr. Grosche observed. He had the impression that the staff, in advising the authorities on the necessary adjustment measures, had sought to minimize their adverse impact on basic human needs. Riots and the need to suppress opposition to government measures were of course regrettable, but they could perhaps be avoided if national authorities followed the Fund's advice in good time. He fully concurred with the staff's conclusion that unless the Dominican Republic took determined action, the adjustment would have to be more severe. Lack of efficiency was the main problem. The allocation of resources was misdirected by incorrect relative prices; market forces would have to play a greater role, starting with exchange rates and interest rates.

On exchange rates, some progress had been made by shifting most current transactions to the parallel market, Mr. Grosche remarked. The main items still excluded were debt service and petroleum imports. As Mr. Kafka had stated, the authorities were moving to transfer petroleum imports--except those by the Electric Corporation--to an intermediate market with a surcharge of 50 percent in relation to parity. While that move was welcome, it was nonetheless regrettable that the number of exchange rates would multiply instead of being merged. In that connection, he asked, first, what plans were being made to deal with debt service and capital transactions. Second, after the rate for petroleum imports had been raised by 50 percent, how much further would the rate have to be moved to reach the rate on the parallel market? Finally, was any action being considered to increase the tariffs of the Electric Corporation, one measure that might make it possible to raise the rate at which the Corporation imported petroleum to more market-oriented levels?

An adequate exchange rate policy would have to be supported by firm fiscal and monetary policies, as the staff had stated, Mr. Grosche went on. The Government was to draw up fiscal measures detailed by the staff, and further information on the state of implementation of those measures would be helpful, particularly with respect to expenditure cuts and further tax increases, including a broadening of the base of the general sales tax. It was also important to allow the public enterprises to set remunerative prices.

In the monetary as well as the fiscal area, the authorities agreed on the need for action but hesitated to take the appropriate measures, Mr. Grosche noted with concern. As he had already mentioned, the most essential action would be to increase interest rates to market-oriented levels. He had come to more or less the same conclusion as Mr. Kafka, that "if these plans can be fully realized, prospects for an improvement in the Dominican situation in the last half of this year are favorable."

He hoped that the authorities would be able to move ahead quickly and at the same time receive acceptance from all sectors of the population of the necessary sacrifices, as Mr. Kafka had put it.

It would be helpful to have some clarification of the authorities' intention to carry out their understanding with the Fund in the form of a bridge or shadow program, Mr. Grosche commented. He could agree to prior action, which should, however, be followed as soon as possible by a formal stand-by arrangement to replace the extended arrangement.

Mr. Clark said that he welcomed the 1984 Article IV consultation as an opportunity to encourage the Dominican Republic, despite present difficulties, to persevere with its adjustment efforts. He recognized the size of the task faced by the authorities. But, as the staff had stated, further delay in taking the necessary policy action would not make the adjustment any easier. Therefore, he hoped that the authorities would seriously consider replacing the inoperative extended arrangement by a new stand-by arrangement based on a program along the lines suggested in the staff papers. In the present circumstances, such a course would be preferable to a shadow program that would avoid normal Fund monitoring. On that same point, the meaning of Mr. Kafka's reference to the authorities' "understanding with the Fund in the form of a bridge (or shadow) program" was not clear to him, in the light of the failure to agree on the terms for a second year of the extended arrangement.

The key elements of a new program would, in his view, be the restoration of an appropriate pattern of prices, including the exchange rate and interest rates, and the containment of the public sector deficit to an amount consistent with available foreign financing, Mr. Clark added. If the authorities were able to act along those lines with determination, they could improve the international competitiveness and general efficiency of the economy and also facilitate further debt rescheduling.

The small decline in the overall public sector deficit during 1983, compared with the programmed reduction of 2 percent of GDP, had been rather disappointing, Mr. Clark commented. He agreed with the staff that for 1984 and beyond there was no room for domestic financing of the budget deficit. Consequently, to the extent that financing from abroad was not forthcoming, spending would have to be reduced or revenue increased. On the revenue front, the introduction of the general sales tax late in 1983, albeit with a broad list of exemptions, and the changes in the valuation base for import taxes since then had been welcome steps in the right direction. Even so, the staff had estimated that the authorities' budgetary plans for 1984 implied an overall domestic financing requirement of some RD$110 million, raising the question of how to close the gap. The staff had made some useful suggestions that he commended to the authorities, particularly the abolition of exemptions to the general sales tax.

The staff estimate of high underemployment suggested that there might be scope for reducing employment in the public sector, Mr. Clark remarked. The poor financial performance of the public sector enterprises had

contributed heavily to the overall public sector deficit, and those enterprises should be allowed to set remunerative prices. He welcomed the expected reduction in the deficit of the State Sugar Company (CEA) but the recent fall in the world price of sugar prompted him to ask how that price compared with the pattern of domestic costs and prices of sugar in the Dominican Republic, and what the effect of the fall would be on the deficit of the CEA. Moreover, would sufficient domestic resources be available to match the foreign financing of the CEA's ambitious investment program? The expected reduction in the deficit of the Electric Corporation, as a result of its improved ability to collect revenues due to it, was also welcome. For the future, it would be important for the Corporation to be permitted to pass on fully any increase in its petroleum costs by raising electricity tariffs.

Growth of the monetary base needed to be limited during 1984, with no net credit extension to the public sector, as the staff had mentioned, Mr. Clark went on. The large foreign exchange losses of the Central Bank must be a matter for serious concern; those losses had apparently been compounded by the Central Bank's failure to charge and to collect adequate interest rates on credit to the public sector. The problems of the Central Bank underlined the necessity for determined fiscal measures, as well as for action on the exchange rate. At the same time, he joined the staff in urging the authorities to implement a more flexible interest rate policy.

The ongoing collaboration between the staffs of the Fund and World Bank was constructive, Mr. Clark said. It had been useful to find reference in the staff report to the World Bank's recent analysis of the Dominican Republic. Practical suggestions had been put forward in that analysis for structural improvements in the economy; the authorities should speed up their consideration of them and reach agreement with the World Bank on the necessary measures. He had noted in particular the recommendation to scale down substantially the public investment program. He had also been interested to learn that the World Bank believed the Dominican Republic to have considerable untapped agricultural potential, much of which could be exploited if price disincentives were eliminated.

The exchange rate regime was a key factor in external policies, Mr. Clark noted. The transfer in April of all imports other than petroleum imports to the parallel market had represented a significant move in the right direction, but an adjustment of the exchange rate for imports of petroleum products was also clearly necessary. The further step mentioned by Mr. Kafka--the shift to an intermediate market of petroleum imports other than inputs to the electricity industry--would take things a stage further, but the timing seemed uncertain. It would also be useful to have the latest information on developments in domestic petroleum prices. In conclusion, he endorsed the staff appraisal.

Mr. Donoso commented that during the first year of the extended arrangement, the authorities of the Dominican Republic had taken major steps to restore equilibrium and stability to the economy. Nevertheless,

imbalances remained, and there was a need for additional fiscal and monetary adjustment. If domestic expenditure were reduced to facilitate an orderly reduction in the deficit on the current account of the balance of payments, it should be possible to simplify the exchange and trade system, thereby achieving a more efficient allocation of resources and making faster economic growth possible.

In proceeding in that direction, the authorities had a large task ahead of them, Mr. Donoso acknowledged. The subsidization of many products and sectors of the economy would make it difficult to achieve the desired balance and eliminate distortions without affecting the cost of living of the population, which had already expressed strong opposition to the Government's economic policies. However, it was clear that the excess fiscal expenditures, with the resulting pressures for credit expansion and the effects on the external accounts, were not sustainable. Therefore, he stressed the importance of the staff's recommendation that the authorities continue to reduce public sector imbalances. It would be essential to complement the measures already taken by the Government to increase revenue, such as the general sales tax that had taken effect in late 1983 and the increase in the customs valuation base, by broadening the base of the value-added tax as well as reducing incentives to investment and exemptions from import duties. It also seemed necessary for the authorities to consider the staff's recommendation to reduce public sector investment spending in line with the World Bank's analysis and to allow public enterprises to set remunerative prices.

The need for the Central Bank to strengthen its gross foreign reserve position and to repay reserve liabilities called for a tight monetary policy, Mr. Donoso noted. Every effort should therefore be made to reduce the public sector deficit to avoid the need for domestic financing. At the same time, appropriate interest rate policies would have to be followed to provide the stimulus for growth of domestic financial assets and to contain capital outflows.

Significant steps had been taken toward unification of the exchange markets, Mr. Donoso remarked. All payments for current transactions, except for imports of petroleum and debt service, had been transferred to the parallel market. The exchange rate incentive for traditional exports had also been increased and was being applied to exports of services as well. He had taken note of Mr. Kafka's statement that the authorities were contemplating additional measures in the same direction, so that only the servicing of public and existing private debt and payment for petroleum imports of the Electricity Corporation would be made at the official exchange rate. Decisive action would be vital to the resumption of stability and to the recovery of growth in production and employment. If the authorities maintained their commendable and courageous attempt to establish a more efficient exchange system, eliminate subsidies, and bring the deficit of the public sector under control, the economic situation would soon improve.

The Fund could make an important contribution toward supporting the authorities' present efforts, Mr. Donoso considered, either by supporting an explicit adjustment program or by providing various types of technical assistance. He hoped that the current program could be resumed shortly, or that a new one could be devised.

Mr. El-Khouri said that he was in general agreement with the staff's analysis and conclusions. In late 1982, the authorities had adopted a medium-term stabilization program supported by an extended arrangement with the Fund. Adjustment at the beginning of the program period had been significant, but the effort had been relaxed during the later part of 1983. Consequently, the economic and financial situation had failed to improve as expected during the year. The adjustment effort had continued in 1984, and a number of major corrective measures had been introduced. Unfortunately, the effort had again fallen short of what was needed because the severe social disturbances in April had understandably slowed down the adjustment process. However, he had been pleased to learn from Mr. Kafka's statement that the authorities had decided to resume their adjustment efforts in the context of what would initially be a shadow program with the Fund, to be followed by a formal stand-by arrangement.

The pursuit of a more flexible exchange rate policy would help greatly in bringing about an improvement in the external payments situation, Mr. El-Khouri considered. Commendable action had been taken earlier in 1984 to transfer additional imports to the parallel market, as well as to simplify the exchange system. That action, together with the further measures being considered to transfer petroleum imports to an intermediate market between the official and parallel market, went in the right direction. Nevertheless, the exchange system remained highly complex, and the authorities should pursue with vigor their effort to achieve the desirable goal of unifying the exchange markets.

Unless exchange rate action were accompanied by appropriate policies in other areas, however, the hoped-for improvement in the balance of payments position would not occur, Mr. El-Khouri observed. In particular, it was necessary to strengthen the financial position of the public sector. Despite a commendable increase in revenue, the ratio of the public sector deficit to GDP had shown only a marginal decline in 1983, with expenditures exceeding the targets in the program. Furthermore, the staff was projecting public sector deficits for 1984 and 1985, only about two thirds of which could be covered by foreign financing. The need for domestic financing was therefore likely to be considerable unless corrective measures were taken to strengthen revenue and control public sector expenditure. The operations of the Central Government as well as those of the major public enterprises would have to be strengthened. He wished the authorities well in their endeavors.

Mr. Rodriguez said that the Dominican Republic's economy had obviously been severely affected by international developments well beyond the authorities' control. They therefore deserved credit for having been

able to make all the purchases during the first year of the arrangement and to achieve several of the program's objectives, even though the pace of adjustment might have been slower than initially expected.

It was encouraging to note that the Dominican Republic authorities were preparing a courageous set of measures designed to overcome present difficulties while gaining the social consensus needed to ensure full implementation, Mr. Rodriguez added. Therefore, he fully supported the authorities' intention to carry out their understanding with the Fund in the form of a bridge program to be succeeded by a formal stand-by arrangment, along the lines indicated by Mr. Kafka.

The staff representative from the Western Hemisphere Department said that the negotiations on the second year of the extended arrangement had been most difficult, mainly because of the presence of large fiscal imbalances and extensive subsidies. The latter had caused a massive transfer of resources from production to consumption. Time and much patience would be required to reverse that situation; however, the Government would have to find the will to act quickly to solve many of the country's more immediate problems, including those pertaining to the balance of payments.

During the discussions with the Dominican Republic authorities in September and October 1983, the staff had been given a projection for the budget that called for domestic financing of RD$400 million, a totally unrealistic proposal because of the meager international reserves of the Central Bank, the staff representative explained. That impasse had halted the negotiations and forced the mission to return to Washington. On its return to Santo Domingo in February 1984, the staff had been presented with an adjusted and more reasonable budgetary program; however, the large exchange rate depreciation that had taken place in the meantime in the parallel market--from RD$1.50 to RD$3.20 per dollar--had created a further stumbling block in the negotiations. The staff had asked the Government to consider transferring a good number of import payments to the parallel market in order to restore some balance to the official market and to stem exchange losses by the Central Bank. During the March 1984 visit, the staff had insisted on the need for a major structural reform of the exchange system. Agreement had finally been reached with the authorities on a massive transfer of import payments to the parallel market, together with an increase in the prices of petroleum products, which were to be imported through an intermediate market rate. Some of those measures had been adopted in April 1984, but the second phase of that agreement, including the measure to transfer petroleum imports to the intermediate market, had not been put into effect because of the outbreak of riots.

After lengthy consultations with the political authorities and Congress, the Government had decided, in May 1984, that the measures discussed previously could no longer be delayed, and had advised the staff that it was in a position to put those measures into effect, the staff representative from the Western Hemisphere Department concluded. However, there was still the problem of how to meet the the petroleum bill of the Electricity Corporation, which imported oil worth almost $150 million a

year, representing almost one third of the country's import bill. The Government had been hesitant to increase electricity tariffs, yet it could not afford to continue subsidizing the cost of electricity to such an enormous extent; the alternative had been central bank financing of the public sector deficit, but such financing made it impossible to design a monetary program. The idea of a shadow program was to encourage the authorities to take some measures that would prevent a further deterioration while giving them time to develop a tax package or to increase electricity tariffs so as to fill the remaining gap. Meanwhile, the Dominican Republic was seeking the support of the Fund so that its foreign creditors would not cut off financing altogether. The staff believed that the implementation of all those measures in the near future would have the effect of increasing the possibility of an agreement with the authorities on a new program.

Another staff representative from the Western Hemisphere Department explained that the intermediate rate to which the authorities intended to move petroleum imports would not reach the current rate in the parallel market of about RD$2.80 per dollar. An intermediate rate of RD$1.50 or even RD$1.75 had been considered. The parallel-market rate would not necessarily remain at RD$2.80, but might appreciate as some transactions were moved into that market. At present, the exchange rate in the parallel market was heavily affected by the imbalances between the official and the parallel exchange markets. Official transactions, including debt service and borrowing by the public sector, were still taking place at the official exchange rate, as were private sector capital transactions that had been agreed to in the past. Capital transactions entered into by the private sector since April 1984 were being carried out at the exchange rate on the parallel market.

The petroleum prices prevailing in the Dominican Republic had not yet been changed from those described in the staff reports, the staff representative added. In addition, the cutting back of investment programs, particularly in the public sector, would have a measurable effect on employment. It was unfortunate, but the lack of available financing had left the authorities with no choice.

The drop in the price of sugar had been one of the factors affecting the finances of the sugar company (CEA), the staff representative from the Western Hemisphere Department noted. However, the CEA faced additional problems stemming from inefficiency and from outdated equipment and facilities. The program being sponsored by the World Bank would imply a modernization and upgrading of those facilities and an improvement in efficiency. As long as the world price for sugar remained depressed, the prospects for the finances of the CEA would not be bright.

The Deputy Director of the Exchange and Trade Relations Department assured Miss Bush and other Directors that the shadow program would in no way be a replacement for a program supported by a stand-by arrangement.

Mr. Kafka said that his authorities, more than anyone, regretted the lack of progress toward adjustment. As he had mentioned in his statement, the present President was trying indefatigably to promote a social contract or understanding on the part of the people that, after many years, the country could no longer avoid facing up to the need for serious economic adjustment. In traveling around the country, and speaking to various sectors of public opinion, the President had been breaking that message to the population, explaining with considerable success the difficulties that the adjustment would create. Indeed, the Minister of the Presidency had been able to state on television that a move would be made in the direction of an upward adjustment of petroleum prices. The authorities were also well aware that the deficit of the Electricity Corporation would have to be dealt with in a financially sustainable way.

Shadow programs were not new in the history of the Fund, Mr. Kafka concluded. The shadow program for the Dominican Republic should please those Directors who argued constantly for a reduction of member countries' access to the Fund's resources, because access was zero under a shadow program. Such a program, in the opinion of the Fund, was one that was insufficiently strong to lead to a definite improvement in the balance of payments, although it would lead to an improvement. Another characteristic of a shadow program was that it included several measures designed to improve the economic and financial situation, beyond what would otherwise have been foreseen, and that would be monitored by the Fund. He was not in a position to provide further information on the exact timing of some of the measures that the authorities considered essential to an improvement of their situation.

The Acting Chairman made the following summing up:

> Directors recognized the severe external and internal economic imbalances with which the authorities had been confronted on assuming office in August 1982. Noting that the authorities had adopted a medium-term economic program under an extended arrangement, Directors expressed disappointment that the adjustment during the first year of the arrangement had been less than envisaged and that understandings had not been reached on policies for the second year of the program. Directors drew particular attention to the further widening in the current account deficit of the balance of payments in 1983 and to the limited progress that had been made in reducing the financing requirements of the public sector.
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> While recognizing the political difficulties involved, Directors emphasized that the magnitude of the economic imbalances in the Dominican Republic made it very important that the adjustment effort be strengthened promptly. In the absence of such action, there was a real prospect of an acceleration in inflation, further currency depreciation, and declining economic growth. There was concern that such developments would work to increase social and political strains.

Directors welcomed the measures recently taken by the authorities toward the unification of the exchange rate. In particular, Directors referred to the transfer to the parallel market of nontraditional exports and of all current payments other than for petroleum imports. Directors observed that further action in that area was required. They were pleased to learn that the authorities were about to make a major change with respect to the exchange rate for petroleum imports, but regret was expressed that it would not as yet include petroleum imports for the Electricity Corporation. Directors noted that the prospective adjustment would inevitably require sizable increases in the prices of petroleum products, which had been subsidized by an overvalued exchange rate.

Directors stressed that measures in exchange rate policy would need to be supported by firm fiscal and credit policies if inflation were to be contained and if resources were to be released to strengthen the balance of payments. Directors were encouraged by the revenue measures adopted in early 1984, which raised the general sales tax and increased import duties. However, they stressed that further efforts would be required to reduce the borrowing requirement of the public sector and agreed with the staff's view that there was no room for domestic financing of the public sector. Apart from expenditure cuts, Directors recommended a further broadening of the tax base, including the elimination of existing exemptions. It was also stated that efforts to broaden the tax base should be made in a manner that would not discourage productive activities. Directors also underlined the importance of ensuring that the public enterprises cut costs and set remunerative prices or tariffs. In particular, tariff increases in the Electricity Corporation were viewed as appropriate to permit the elimination of subsidies associated with the price of oil imports and to eliminate any remaining deficit.

In monetary policy, Directors recommended that a more flexible interest rate policy should be pursued, within the framework of a suitable financial program, to achieve and maintain positive real interest rates on all instruments. They noted that pursuance of such a policy would support the authorities' objective of securing a deceleration in credit expansion and also would discourage capital outflows and improve savings. They pointed to the importance of having the Central Government pay market interest rates on its use of central bank resources.

Directors noted the Dominican Republic's accumulation of external payments arrears and the multiple currency practices characterizing its exchange system. They urged that every effort be made to eliminate those practices within the context of an adjustment program. Directors drew particular attention

to the fact that the persistence of external payments arrears was hindering the country's efforts to re-establish its creditworthiness.

Directors stressed the importance of careful external debt management. Approaches had been made to partner countries and commercial banks for the rescheduling of obligations falling due through 1985. Directors noted that a restructuring would have lasting beneficial effects only in the context of a medium-term strategy which would aim at reducing fiscal deficits and at substantially limiting the need for external borrowing. Directors noted that the reform of exchange rate and interest rate policies would contribute to improving economic efficiency. However, additional structural reforms were needed if the authorities' longer-term objectives with respect to economic growth and employment were to be attained. Directors urged the authorities to implement the World Bank's recommendations in that respect, especially as they related to the public sector or to the general public investment program. It was noted that among other development-related actions, more flexible pricing policies would permit the Dominican Republic to realize its broader agricultural potential.

Directors also noted that the authorities had remained in contact with the Fund staff and encouraged such contact. They hoped that understandings soon would be reached on an adjustment program that could be supported by the use of Fund resources.

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

APPROVED: May 23, 1985

LEO VAN HOUTVEN
Secretary