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Minutes of Executive Board Meeting 84/168

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

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	M. K. Bush
	H. G. Schneider
	G. E. L. Nguyen, Temporary
M. Finaish	T. Alhaimus
	K. Murakami, Temporary
G. Grosche	
J. E. Ismael	
	L. Leonard
	H. A. Arias, Temporary
	A. Vasudevan, Temporary
	A. Abdallah
	M. A. Weitz, Temporary
	J. E. Suraisry
	G. Ortiz
J. J. Polak	
	A. V. Romuáldez
	R. Msadek, Temporary
	E. Olsen, Temporary
	T. A. Clark
	N. Coumbis
Zhang Z.	

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

Also Present

Exchange and Trade Relations Department: S. Kanesa-Thasan. Fiscal Affairs Department: V. P. Gandhi. Legal Department: J. K. Oh, J. V. Surr. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; G. T. Abed, R. H. Floyd, S. H. Hitti, B. A. Karamali, A. Kayoumy, K. Nashashibi. Western Hemisphere Department: J.-P. Amselle, M. Caiola, J. E. Sundgren, G. L. Terrier, G. Yadav. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: E. A. Ajayi, D. Hammann. Assistants to Executive Directors: J. Bulloch, M. B. Chatah, G. Ercel, G. D. Hodgson, H. Kobayashi, M. Lundsager, D. J. Robinson, A. A. Scholten, Shao Z., A. H. van Ee.

1. YEMEN ARAB REPUBLIC - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with the Yemen Arab Republic (SM/84/228, 10/18/84), together with a proposed decision concluding the 1984 Article XIV consultation. They also had before them a report on recent economic developments in the Yemen Arab Republic (SM/84/248, 11/7/84), and a paper on a change in Y.A.R. exchange arrangements (EBD/84/300, 11/20/84).

Mr. Finaish made the following statement:

> The performance of the economy of the Yemen Arab Republic in the five years up to 1980 was characterized by rapid growth and financial stability, the achievement of which was helped by inflows of workers' remittances and official assistance from neighboring countries. During this period important steps were taken toward the establishment of basic economic and social infrastructure. While the trend of noninflationary growth continued in the period 1980-82, financial strains, particularly in the external account, began to emerge. These strains, compounded by the effects of a major earthquake in 1982, were manifested in the substantial increase in the current account deficit and the emergence of an overall deficit after years of recorded surpluses. Consequently, the level of external reserves declined during the period. An important factor behind these adverse developments was a slowdown in both workers' remittances and official assistance. The fiscal position during this period also came under pressure, with the increase in expenditures outpacing that in revenue. By 1982 the overall budget deficit had increased considerably, the bulk of it being financed by domestic bank borrowing. As a result, and despite the contractionary effect of the decline in net foreign assets, the rate of liquidity expansion accelerated markedly during 1982, putting additional pressure on the Yemen rial, which was officially pegged to the U.S. dollar.
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> In response to these adverse developments, the authorities have during the past two years embarked on an adjustment policy designed to reverse the growing financial imbalances and to steer the economy toward a path of sustainable noninflationary growth. In support of this policy, a number of significant measures have been taken in the fiscal, monetary, and exchange rate areas.
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> The authorities recognize that a fundamental problem behind the worsening of financial conditions is the growing fiscal deficit. Thus, a number of steps were taken in 1983 to increase domestic revenue and contain expenditures. On the revenue side, efforts were concentrated on improving tax collection. The success of these efforts was reflected in a 14 percent increase in the collection of taxes on income and profits despite the

unchanged tax rates, and a 25 percent increase in the collection of zakat (a religious tax). In addition, a number of specific revenue measures were taken, including higher taxes on motor vehicles and increases in tariffs on certain luxury goods. Overall tax revenue in 1983 was 24 percent higher than in 1982; these figures do not include the proceeds from revenue measures introduced in 1983, which were earmarked for the earthquake reconstruction effort and administered by a special council set up for that purpose. However, in spite of the substantial increase in domestic revenues, the large drop in foreign grants--by about two thirds--in 1983 resulted in a 10 percent decline in total revenue.

On the expenditure side, the policy of restraint was reflected in a 9 percent reduction in total government spending in 1983. In adjusting expenditures to the shortfall in total revenue, however, most of the cutbacks were borne by capital outlays. After a quarterly review of the budget indicated the need for further cuts in expenditures to contain the deficit, a decision was taken to stop implementing new projects financed from domestic sources. Most of the cutbacks were in the areas of defense, education, agriculture, and construction. Although current expendītues increased, the wage and salary bill increased only marginally and actually decreased in real terms. The increase in domestic tax revenue, combined with the policy of expenditure restraint, offset the large decline in external assistance, thus resulting in a 9 percent reduction in the overall budget deficit.

The policy of fiscal adjustment continued in 1984. Additional revenue measures were introduced, including higher user charges and fees for health and educational services. Moreover, continued improvements in the administration of the tax on income and profits have increased collections by 11 percent in the first six months of 1984 and an even larger increase is expected for the year as a whole. In spite of a further drop in external grants, total revenue in 1984 is projected to increase by about 10 percent. With respect to expenditures, the measures taken in 1983 were maintained in 1984. In addition, capital transfers to public authorities and companies were discontinued, except for those to the water and electricity authorities required under World Bank loan agreements. These authorities and companies are not required to finance their capital requirements from the Central Bank, with a government guarantee. This is expected to result in more commercially oriented operations, as the loan would have to be repaid. Moreover, current transfers are expected to fall, as operating subsidies to most public authorities have been eliminated. At the same time, public enterprises are expected to show increased profits resulting from improvements in efficiency and higher output. Wage increases in public enterprises are being limited by the provision of new retirement pension schemes. Furthermore, a special committee has been established to meet periodically with each enterprise to review progress in increasing efficiency. An important aspect of expendiure policy in 1984 is the emphasis on cutting current outlays, thus allowing some increase in capital spending, which had declined significantly in the previous year. Capital expenditures in 1984 are projected to be 7 percent higher than in 1983. The overall budget deficit is expected to register a decline of about 9 percent.

Primarily as a reflection of bank financing of the budget deficit, the rate of liquidity expansion since 1982 has been relatively high. Although strong inflationary pressures have not yet developed, partly because of the openness and continuing monetization of the economy, the authorities are mindful of the potential adverse effects of excess liquidity on financial stability. While recognizing that the fundamental solution to this problem lies in further reductions in the fiscal deficit, they are also taking other measures to absorb the excess liquidity. These include an increase in the reserve requirement, the introduction of a government bond scheme expected to be finalized in the near future, and the establishment of a number of mixed enterprises to provide greater investment opportunities to private citizens. In addition, consideration is being given to the establishment of an Islamic Bank. With respect to interest rates, the authorities consider that the present borrowing and deposit rates remain appropriate, since these rates are positive in real terms and at the same time allow an adequate measure of profitability to commercial banks. The increase in the foreign currency deposits of residents in commercial banks and the willingness of banks to increase their lending to the private sector are indications of the adequacy of the interest rate structure.

If the success of the adjustment policy is to be measured in terms of the balance of payments outcome, the results so far are encouraging. In 1983 both the current and overall balances recorded significant declines. A major contributor to the outcome was a decline in imports resulting from a drop in overall demand as well as the tightening of the import licensing system and depreciation of the Yemen rial in the free market. The decline in imports in 1983 more than offset the decline in transfer receipts from official sources. Balance of payments projections for 1984 indicate a much more substantial turnaround, with the current account deficit dropping by about 75 percent from its 1983 level. The capital account is expected to register a small surplus. This favorable forecast is a reflection of the continued tightening of fiscal policy, the increased flexibility of the official exchange rate since late 1983, as well as the specific measures aimed at limiting imports, particularly luxury goods.

With respect to exchange rate policy, as the pressures on the balance of payments intensified and the official rate of the Yemen rial vis-à-vis other currencies continued to appreciate with the U.S. dollar to which it had been pegged, the authorities decided in late 1983 to follow a more flexible policy. Since November 1983 a number of devaluations of the Yemen rial have been made, the most recent of which occurred only three weeks ago. Over the past year, the overall movement in the Yemen rial vis-à-vis the U.S. dollar has been about 30 percent. It is not the policy of the Yemen Arab Republic to follow closely the free market rate.

The authorities wish to emphasize that the main objective of the recent changes in the import licensing system and the restrictions on the use of certain foreign exchange deposits to finance imports was to limit and improve the composition of imports on the basis of priority. Following the recent discussions with the staff on this question, the authorities intend to change existing procedures as soon as possible in order to eliminate those elements which are considered by the Fund to be exchange restrictions.

The Yemen Arab Republic continues to follow a prudent policy with respect to external borrowing. Since 1981 all government and public sector loans have been subject to strict control. The debt service ratio remains low, at about 4 percent.

In conclusion, the Yemen Arab Republic has been pursuing an adjustment policy aimed at achieving internal and external financial stability, while creating conditions appropriate for the restoration of sustained growth. The authorities recognize that for this effort to succeed fully, additional steps, particularly in the fiscal sector, need to be taken. Moreover, the substantial improvement in the balance of payments achieved so far is an indication of the strength and seriousness of that effort, especially when viewed against the backdrop of the drought conditions in the last two years, which resulted in a substantial decline in agricultural output and led to a sharp increase in certain good imports. The authorities are determined to continue their adjustment effort and look forward to further useful exchanges of views with the staff on the policies being pursued.

Mr. Suraisry said that he was in broad agreement with the main points in the staff appraisal, and that he supported the proposed decision. The economy of the Yemen Arab Republic had witnessed some improvements in certain areas in 1983 and so far in 1984, even though the growth rate had declined to 1 percent in 1983. The overall fiscal deficit and domestic bank financing of the deficit had been brought down, external imbalances had been reduced, and official reserves had increased. However, it was clear from the staff reports that without additional corrective measures, those improvements would be difficult to sustain. Gross fixed investment had declined, imports had been reduced substantially, and the fiscal deficit was still very large. The authorities evidently recognized that situation and were determined to improve it.

Referring to production and investment policies, Mr. Suraisry noted that some of the targets had fallen short, including those for exports, fixed investment, and the ratio of government consumption to GDP, during the first two years of the Second Five-Year Development Plan (SFYP). Extrabudgetary expenditures were one reason for the unfavorable outcome, and it was encouraging to note that the authorities intended to correct those inadequacies by formulating more effective annual plans; however, he would be interested to know whether that meant they were abandoning the five-year plan.

Another reason for the failure to meet some of the targets of the SFYP, Mr. Suraisry went on, was that over the past few years, while agricultural policies had been generally appropriate, the contribution of the agricultural sector to real GDP had fallen, mainly due to the drought and to the 1982 earthquake. Those events were obviously beyond the authorities' control, but agricultural prospects could be improved if bottlenecks in marketing and distribution were tackled. In that connection, he welcomed the authorities' intention to reduce current expenditures in 1984 so as to increase capital spending. He also welcomed the World Bank's contribution to the Yemen Arab Republic's development efforts, including agriculture; in that connection, the information provided in Appendix VI of the staff report was very useful.

The overall fiscal deficit had been reduced, but it nevertheless remained unsustainable, as the staff had noted and as the authorities were aware, Mr. Suraisry remarked. Several measures had been taken to enhance revenue, and he was particularly glad to note the efforts to improve tax administration and to collect tax arrears. But to be effective, those measures would have to be supplemented by better control of expenditure. Granting the public enterprises more flexibility in setting their prices would be helpful in that endeavor, which he realized would not be an easy one, although like the staff he believed that expenditure control was necessary if the overall deficit was to be reduced.

It was important to achieve a reduction in the overall deficit in order to absorb excess liquidity in the economy, Mr. Suraisry added. The growth rate of domestic liquidity had increased from 8 percent in 1981 to 41 percent in 1984, based on the trend observed in the first half of the year. If that trend continued, the gains achieved on the inflation front could be undermined. Fortunately, the authorities had taken measures to absorb excess liquidity, including the establishment of an Islamic Bank.

The external sector had recently come under pressure, leading to the imposition of some restrictive measures, which had modified somewhat the free exchange and trade system that had long characterized the Y.A.R. economy, Mr. Suraisry observed. However, he had been encouraged by the authorities' decision to review those measures, and he was confident that they would do their utmost to liberalize them. Their recent and commendably flexible approach to exchange rate policy constituted an important part of that effort, and the latest information on the exchange rate was an indication of the authorities' determination to continue that policy.

As the staff had correctly recognized, remittances were important to the Y.A.R. economy, and it had commented on the factors behind their decline, Mr. Suraisry noted. An additional important factor was the decision of a large number of Yemeni workers, irrespective of economic conditions in neighboring countries, to return to their own country to take advantage of the new opportunities created by recent inflows of capital into the Y.A.R. economy. Thus, while the return of workers might have a direct negative impact on the balance of payments, it could have an indirect positive impact; many workers were returning with better skills, enabling them to contribute to the country's import-substitution efforts, and reducing the need for expatriate labor. In the medium and long run, as the supply of skilled labor and entrepreneurs increased, the whole development process should benefit.

In sum, Mr. Suraisry remarked, the Yemen Arab Republic faced difficult economic problems, and although the authorities had taken a number of commendable actions, continued efforts would be needed to resolve them. The discovery of oil was encouraging, and if oil recovery was commercially feasible, it could help in alleviating the balance of payments problem.

Ms. Bush noted that a period of impressive economic achievement during most of the 1970s had been succeeded by troublesome developments over the past two years. Although certain problems had been exacerbated by external factors, some potential danger of further weakening existed in the fiscal and external sectors. She urged the authorities to continue their efforts to prevent any such worsening, underscoring specifically the need for expenditure reduction. While noting the plans the Government had made to deal with the fiscal imbalance, she stressed the need to adjust future budgets to reflect lower external grants. The authorities should also be cautious about relying too heavily on projected oil revenues to support future spending.

The flexible approach adopted by the authorities toward the exchange rate was commendable and should be complemented by appropriate macroeconomic policies, Ms. Bush considered, particularly with respect to government expenditures and domestic liquidity, in order to reach a sustainable balance of payments position. In supporting the proposed decision, which would approve measures that constituted exchange restrictions, she was nevertheless somewhat concerned that the authorities had seen the need for introducing such restrictions; their former trade and payments system, which had been basically free of restrictions, had seemingly served the economy well.

In conclusion, Ms. Bush commended the authorities' policy of limiting direct investment by the Government to fields in which the private sector was unable or unwilling to participate.

Mr. Grosche remarked that it seemed clear from the staff report that the authorities should be concerned above all with the large fiscal deficit and the growth of government expenditure, which was probably at the root of most of the Yemen Arab Republic's current problems. Government expenditures in relation to GDP had grown from 43 percent in 1978/79 to almost 60 percent in 1983, according to Table 8 of SM/84/248; the increase was worrisome because it had been caused by current and extrabudgetary expenditures. Furthermore, he had the impression that the additional demand stemming from that spending had led almost exclusively to a larger volume of imports and not to an increase in domestic output. Yet the assessment by the World Bank staff in Appendix V of SM/84/228 described the Y.A.R. economic performance as broadly satisfactory. He asked the staff whether its views differed widely from those prevailing in the World Bank, or whether the Bank staff's assessment reflected simply its greater interest in long-term developments.

The question of how best to deal with the budget deficit was not easy to answer, Mr. Grosche continued. He welcomed the tax efforts already undertaken, and joined the staff in urging the authorities to implement the tax measures under consideration as quickly as possible. It was doubtful however that taxes could or should be increased enough to offset the deficit, which in his view would have to be reduced through a cutback of current expenditures. He had missed in the staff report more detailed information on those items of current expenditure that might offer the necessary room for maneuver. Cutting wages would seem to be difficult, considering that public sector wages on average were only 50 percent of wages in the private sector. Cuts in subsidies to public enterprises should be possible. Perhaps the staff or Mr. Finaish could offer further indications of the scope for curtailing current expenditures.

A reduced budget deficit should also be helpful in curbing the excessive growth of liquidity, Mr. Grosche noted. Government borrowing had been the main factor underlying the growth of monetary aggregates. Inflation, even though it was still quite low, was on a clearly upward trend. He asked the staff to comment briefly on the adequacy of the recent increase in reserve requirements.

The commitment of the Y.A.R. authorities to a flexible exchange rate policy was gratifying; it should contribute to checking the spillover into the external sector of demand generated by the large budget deficit, Mr. Grosche remarked. Moreover, that flexible stance should foster confidence and thus attract workers' remittances. It remained to be seen to what extent incentives were being provided for import substitution, the prospects for which were not very promising, considering the shortage of internal resources. Moreover, not much could be expected from the export side, given the very limited export base, which was evident from

Appendix II of the staff report. A more flexible exchange rate policy should in any event reduce the spread between the official and the open market rate, if the spread remained following the devaluation.

It was regrettable that two years previously the Y.A.R. authorities had abandoned their liberal exchange and trade policies, which had traditionally served the country well, Mr. Grosche observed. He had therefore been heartened by the announcement that they stood ready to change the existing procedures so as to remove any exchange restrictions as soon as possible. Finally, like the staff, he commended the authorities for their prudent external debt policy.

The staff representative from the Middle Eastern Department noted that in formulating annual plans within the context of the Second Five-Year Development Plan, the Y.A.R. authorities had not intended to abandon the five-year plan but to give themselves an opportunity to set more realistic targets for expenditures and growth, based on an evaluation of the actual performance of the economy each year. It should be borne in mind that the five-year plan relied heavily on flows of external resources, which fluctuated for reasons beyond the control of the authorities. In the judgment of the World Bank staff, it would be difficult for the authorities, in the fourth year of the SFYP, to achieve the overall objectives that had been set. The authorities had recognized that fact, but had made no official move to abandon the targets of the five-year plan.

Based on the continuous dialogue between the staff of the Fund and the staff of the World Bank, it would appear that the World Bank did indeed take a somewhat longer view of the performance of the Y.A.R. economy, the staff representative commented. The staff of the World Bank had taken into account positive developments over the past 15 years in the social and physical infrastructure of the country, including the integration of the country through the road network and the institutional machinery of government that had been built up. The concern of the Fund staff had to be with the financial stability of the country; in that respect, the implications of the fiscal deficit were disturbing. The staffs of the two institutions collaborated closely and regularly; one mission staffed by both the World Bank and the Fund had been to the Yemen Arab Republic two years previously, and a subsequent mission was about to leave to inquire further into the possibilities of raising domestic revenues and mobilizing resources.

Greater flexibility in pricing would enable public enterprises to compete better and perhaps turn their financial positions around from dependence on transfers from the budget to being net revenue earners, the staff representative considered. Although public sector enterprises did not constitute a large proportion of the economy, they did affect budgetary allocations. Extrabudgetary expenditures could be trimmed significantly, even though a certain portion might be related to defense and security. Certain administrative measures were being introduced to control budget expenditure and to operate the civil service and public enterprises more efficiently. Of course, ways of generating additional revenue should not be neglected; those had been discussed with the authorities in general terms and were expected to be the focus of the World Bank staff mission.

It would probably not be feasible to increase the reserve requirement much beyond 20 percent without restricting the operations of commercial banks, thereby leading to some pressure on liquidity, the staff representative noted. As a monetary measure, the reserve requirement by itself was of course of limited effectiveness in dealing with a large and unsustainable fiscal deficit.

The official exchange rate had been used as a way of simplifying accounting and of managing the import bill, the staff representative from the Middle Eastern Department explained. The official and the market rates had not been permitted to deviate significantly.

Mr. Finaish observed that the basic reliance of the five-year plan on external resources made it necessary for the authorities to review the plan annually so as to take into account the availability of resources. During the past few years the economy had come under increasing pressure, owing to a number of factors, including a substantial fall in workers' remittances, a decrease in external assistance by almost two thirds, a major earthquake in 1982--for which the authorities had sought emergency assistance from the Fund, and severe drought for two years. Economic policy over the past two years had concentrated on adjustment measures to deal with the financial strains brought about mainly by the adverse developments he had mentioned.

The major elements of the adjustment policy had been outlined in his opening statement, Mr. Finaish added. Although more would need to be done if the financial imbalances were to be completely eliminated, the improvements already achieved, particularly on the external account, indicated that the economy was moving in the right direction. Moreover, it was extremely difficult to implement fiscal measures in countries like the Yemen Arab Republic, where many areas were still not easily accessible by road and where tribal traditions remained strong. That notwithstanding, tax revenue had reached 20 percent of GDP, a relatively high ratio for an underdeveloped economy; in 1983, revenue had increased by 3 percent of GDP. The collection of taxes on income and profits had increased by 14 percent in 1983, and by 11 percent in the first six months of 1984. The collection of the zakat, a religious tax, had also risen by 25 percent. While the 10 percent reduction in expenditures in 1983 had basically affected capital outlays, the authorities had had no other choice, and in 1984, capital expenditures were expected to rise by 7 percent. In both years, the budget deficit would fall by 20 percent, thanks largely to the impressive tax effort.

In conclusion, Mr. Finaish noted, he did not have enough information at hand to know how large the oil discovery was and whether it could be exploited commercially. If so, he felt sure that the Y.A.R. authorities would bear in mind the experience of neighboring countries in developing those oil resources.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the views in the appraisal of the staff report for the 1984 Article IV consultation with the Yemen Arab Republic. While noting the impressive economic development achieved in the past, they expressed concern about the continued high level of consumption, especially by the government sector, which indicated a need for more vigorous domestic resource mobilization and reduced reliance on external resources. Concern was also expressed about the sizable financial imbalances that had emerged in recent years. Directors noted that the rate of growth had slowed down in the more recent period, during which natural disasters had severely affected agriculture, as well as of the concurrent rise in the rate of inflation. The recent discovery of oil in the Yemen Arab Republic should should not, Directors urged, prevent the authorities from continuing to press ahead with measures to reduce the underlying financial imbalances in the economy.

As regards financial developments, Directors focused their comments on the fiscal deficit, which continued to be large and unsustainable despite a number of measures taken to contain it. Directors underlined the need for prompt action to deal with the fiscal imbalance by adopting effective measures to reduce government spending, including extrabudgetary outlays; to improve the operating results of public enterprises; and to mobilize domestic resources. Directors welcomed the adoption of measures aimed at absorbing the liquidity generated by the fiscal deficit and urged that additional measures be implemented quickly.

Directors commended the authorities' recent flexible approach to exchange rate policy, which they encouraged them to continue. They stressed the critical importance of greater restraint in demand management policies in order to overcome current external imbalances. Directors took note of the intention of the authorities to reconsider exchange and trade restrictions introduced recently and urged that necessary steps be taken to liberalize imports and to return to an exchange system free of restrictions.

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

The Executive Board then took the following decision:

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

2. The licensing of imports in accordance with an exchange budget and the limitations on the use of residents' foreign exchange deposits, as described in SM/84/248, constitute exchange restrictions requiring approval under Article VIII. The Fund notes the intention of the Y.A.R. authorities to eliminate the restrictive elements of these regulations at an early date and grants approval for these restrictions until November 30, 1985 or the next Article IV consultation, whichever is earlier.

Decision No. 7844-(84/168), adopted
November 21, 1984

2. GRENADA - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Grenada (SM/84/240, 10/25/84), together with a proposed decision concluding the 1984 Article XIV consultation. They also had before them a report on recent economic developments in Grenada (SM/84/244, 11/5/84).

The staff representative from the Western Hemisphere Department made the following statement:

On November 7, 1984 the Grenadian authorities announced that an agreement had been reached with the union representing civil servants to increase salaries by 11 1/2 percent on average, retroactive to January 1, 1984. The effect would be to raise expenditures in 1984 by about EC$4.5 million, equivalent to somewhat more than 1 percent of GDP. Although the authorities now expect revenues for 1984 to be somewhat higher than those projected by the staff, there are indications that expenditures--apart from those related to the recent salary increase--also may exceed the staff projection. Under the assumption that all fiscal arrears carried over from 1983 are eliminated, the fiscal gap projected for 1984 is expected to be higher than that estimated in the staff report by EC$4.5 million, the amount of the salary increase.

On October 28, 1984 the authorities decided to abolish estate duties and to exempt government pensioners from income tax on the first EC$7,200 of their annual pension. The staff estimates that the loss of revenue from the adoption of these measures would amount to approximately EC$1 million in 1985. Since the Government has not announced any measures to offset the loss in revenues, and under the assumption that the increase in salaries granted in 1984 would result in additional expenditures of some EC$5 million in 1985, the financing gap projected by the staff for 1985 would increase by EC$6 million, to EC$23 million, equivalent to 6.3 percent of GDP.

Attention had been drawn in the staff report to the difficult fiscal outlook for 1985. The recent actions taken by the authorities, particularly the increase in wages, point to the need to intensify efforts to strengthen the fiscal position. In the light of the latest developments, the tax reform under consideration by the authorities in all likelihood will need to give attention to ways of bolstering fiscal revenues.

Mr. Leonard made the following statement:

The Executive Board has considered economic developments in Grenada in August 1983 (EBM/83/121 and EBM/83/122, 8/24/83). Since then, the country has crossed a watershed in its political and economic affairs.

Following the events of October 1983 and pending elections scheduled to be held next month, the management of national affairs has been entrusted to an interim Government. This administration, in addition to restoring a measure of stability to the island's economy, has undertaken an ambitious program of reversing the dominance of the public sector and of giving greater scope to the operation of private enterprise. In effecting this reorientation the thrust of the authorities' efforts has been in the following directions: (i) giving more play to market forces; (ii) encouraging private enterprise by liberalizing investment guidelines, reforming the taxation system, putting greater emphasis on infrastructural projects in public investment, and rebuilding commercial bank liquidity; and (iii) divesting the state of publicly-owned enterprises and reducing the relative extent of public expenditure.

These measures will take time to implement and still further time to yield the expected results. Nevertheless, the authorities have made a vigorous start in the course of 1984 and, as noted in the staff reports, a range of policy measures are already in place. Exchange controls have been relaxed on a number of external transactions, and both residents and nonresidents are now permitted to open bank accounts in foreign currency. The liquidity of the commercial banks has been restored and a first step taken in raising the ceiling on interest rates. A second step is shortly to follow. The system of price controls is being liberalized and, as part of the move in that direction, decisions have been taken on eliminating the monopoly of the Marketing and National Importing Board on the sale of cement, rice, milk, and sugar. These decisions are being put into effect step by step, beginning with the freeing of cement sales in December 1984 and following through with the others at regular intervals in 1985.

As part of Grenada's efforts to attract foreign private investment, laws and regulations bearing on investment have been codified and an investor's guide, which includes new incentives, was published in September 1984. More substantial revisions in the shape of tax reforms and the provision of further incentives are still pending, but the groundwork for them is being laid. In the meantime the physical infrastructure of the island is being improved. The international airport at Point Saline, which is generally acknowledged now as a key element in securing industrial, commercial, and touristic development, is already in operation, and the emphasis of public investment is turning to electricity supply, roads, port expansion, and the provision of factory shells.

In the review of the taxation system, the authorities, while recognizing the merits of change, regard it as appropriate that the pace of reform should be more deliberate than in other areas. The underlying reasons are set out in the staff report and are referred to later in this statement. Deliberation of pace is also called for in the divestiture of the state of many of its public enterprises. Apart from legal and technical considerations and the issue of compensation that arises in the case of the Grenada Farms Corporation, the full value of the enterprises is unlikely to accrue to the state until present economic and political uncertainties are closer to resolution. Moreover, until there is a reasonable prospect of competence in management continuing or coming about with changes in ownership, there is also a danger of closure of certain enterprises and of resultant unemployment that has to be taken into account in decisions on divestiture.

The restoration of economic stability is seen by the interim administration as a necessary adjunct to structural change. On the external account, the overall balance is expected to move into surplus in 1984 compared with a deficit equivalent to 2 percent of GDP in 1983. For the most part, the surplus derives from the large increase in official grants between the two years, and similar substantial inflows will be necessary in the foreseeable future if an acceptable degree of balance is to be maintained. The current account, by contrast, has been marked by deficits for the past several years and a slight worsening of the negative balance is forecast for 1984. Foreign earnings should, however, improve in 1985 with a recovery in exports of agricultural and manufactured goods and higher tourism receipts following on the opening of the international airport.

The rate of rise in consumer prices has been decreasing steadily from its high point of over 21 percent in 1980. The downward trend continued in 1984 and, for the year as a whole, the average price rise should not exceed 5 percent. Nominal wages have more than kept pace with price rises in recent years and living standards for those at work should have improved, but unemployment remains a major source of concern. An estimate of the unemployment rate made in 1981 put it at over 25 percent; there may have been some improvement in 1982, but it is probable that the situation worsened again with the decline in national output in 1983 and the general stagnation of economic activity in 1984.

In the fiscal area, progress has been limited. At the time of the Fund mission to Grenada in August 1984, the prospects were for a public sector surplus of about 2 percent of GDP--compared with a deficit of over 17 percent of GDP in 1983--and for the elimination of public sector arrears. As in other island economies of the East Caribbean, this outcome was being made possible by very substantial external capital and current grants, the latter being in the particular circumstances of Grenada at a level in 1984 many times greater than normal past levels. The exceptionally high current grants were intended partly to offset sluggish fiscal revenues resulting from uncertainty and low levels of economic activity and partly to enable the interim administration to finance a reduction in government debt to the commercial banks.

The relatively favorable fiscal prospects also depended on the close containment of public sector pay levels. Unfortunately, this condition has not been realized. Dissatisfaction with pay in the public service since the expiration of the last pay agreement at the end of 1983 has grown. In the face of mounting pressure and strike threats, which could have affected the December national elections, the authorities conceded a pay increase which will add some EC$4.5 million to government expenditure in 1984 and correspondingly increase the financing gap indicated in the staff reports. The increase, together with certain other tax concessions announced by the authorities, will also add to the prospective financing gap in 1985.

The interim administration accepts that the fiscal effects of these developments run counter to immediate budgetary desiderata. In their judgment the steps taken were necessary in carrying through their task of holding the December elections in a calm atmosphere and preparing the way for normal political processes in later years. The additions to expenditure will undoubtedly add to the budgetary problems of the incoming administration, particularly in 1985. They underline, furthermore, the need to proceed cautiously with fiscal reform and the enhanced importance of grants and concessionary finance in continuing the process of economic stabilization and development in Grenada.

> The issue of the exchange rate of Grenada's currency has yet to be decided. The interim administration is cooperating in current studies of the exchange rate of the common currency of the Organization of East Caribbean States, which includes Grenada, but these studies are not yet completed. The matter will, therefore, be for consideration by the incoming administration.

Mr. Clark said that he welcomed the market-oriented approach to economic management adopted by the interim Government of Grenada. He had noted in particular the authorities' commitment to end domestic price controls, to transfer a number of state enterprises to the private sector, and to encourage private direct investment, which would be particularly important for future development.

While the general approach to economic policy seemed basically sound, the economy remained heavily dependent on external capital inflows, reflecting the very high level of capital expenditures relative to domestic savings, Mr. Clark continued. The debt service burden had grown substantially in recent years, and according to the staff report, was likely to reach 19 percent in 1985. The Caribbean Development Bank considered that Grenada could not afford further borrowing on other than concessional terms. The substantial increase in external concessionary aid over the past year might indicate no immediate debt problem, but such flows could not be expected to continue indefinitely. The few years ahead would provide a breathing space for the authorities to implement policies to increase domestic savings and strengthen the external sector so that development in the future could be financed without recourse to excessive external borrowing.

Against that background, Mr. Clark added, he had been especially concerned by the recent pay increase awarded to public sector employees. Not only was the increase likely to erode the financial position of the public sector but, in conjunction with Grenada's exchange rate arrangements, it was also likely to weaken the external balance.

The substantial public sector deficits in 1981-83, averaging over 18 percent of GDP, had been largely financed--particularly in 1981 and 1983--through heavy external borrowing, Mr. Clark noted. The dramatic reduction in the overall deficit in 1984 was welcome, but reflected less a change in underlying patterns of expenditures and revenues than a large increase in external concessionary aid. As had been emphasized during the Executive Board's discussion of the 1983 Article IV consultation with Grenada, the first priority on the fiscal side was to increase public savings. In terms of expenditure, pay restraint would be crucial. On the revenue side, the twin objectives of tax reform and increasing public savings might be difficult to reconcile, at least in the short term. As the two reviews of the tax structure commissioned by the authorities had shown, reform was necessary in order to improve incentives for the private sector, although as the staff had mentioned on page 8 of SM/84/240, it could initially lead to a substantial loss of revenue. It might therefore be necessary either to slow the implementation of the tax reform or preferably to take additional fiscal measures. In that context, he would be interested to know more about the likely proceeds from the sales of public sector enterprises, as well as whether any estimates were available of the possible effects of the tax reform on revenue and therefore on public savings over the longer term.

On external policy, the lack of analysis in the staff report of exchange rate policy and debt prospects was disappointing, Mr. Clark said. The relative stagnation of exports over the past few years, together with the 26 percent real effective appreciation of the exchange rate since 1980, raised an important question about the appropriateness of the exchange rate. Most of the comments made by Mr. Prowse during the Executive Board's discussion of the staff report for the 1984 Article IV consultation with Dominica (EBM/84/110, 7/18/84) on the exchange rate policy of the Eastern Caribbean Central Bank (ECCB) were also relevant in the case of Grenada. It would be helpful to know when the review of exchange rate policy being conducted by the ECCB was expected to be completed. In the meantime, it would have been useful to have some analysis of the effect of Grenada's current exchange rate on the economy. For instance, he had noted from the report on recent economic developments that, despite unemployment rates averaging 27 percent, there were still labor shortages in the agricultural sector, which accounted for some 80 percent of merchandise exports. The staff had noted that at least part of the reason was the low level of agricultural wages relative to urban wages; presumably, that was in turn partly due to the external competitive pressures imposed by the present level of the exchange rate on the tradable sector of the economy. In conclusion, he supported the proposed decision.

Ms. Bush said that she joined Mr. Clark in welcoming the commitment of the interim administration in Grenada to a market-oriented approach to economic policymaking. The reduction of the scope of restrictions on prices, interest rates, and the foreign sector constituted the most effective means of restoring both foreign and domestic business confidence. It was important that any new government be committed to a continued liberalization of the economy.

The authorities were aware of the need to reduce the role of the Government through divestiture of public enterprises over a broad spectrum, Ms. Bush continued. Additional enterprises were to be partly privatized, she understood. Such changes would not only have the effect of reducing the public sector deficit--which represented about 25 percent of GDP in 1984, excluding foreign grants--but should increase the operating efficiency of those enterprises because government transfers would no longer be sustaining unprofitable ventures. She was however somewhat concerned about the lack of a timetable for the implementation of those changes, and she hoped that the new Government would work out an appropriate schedule for acting with due speed on those proposals as well as on the recommendation to lower current tax rates. Such action should generate more savings and provide incentives for increased production and private sector investment.

The fiscal situation would remain precarious, even with the proposed divestiture of public enterprises, Ms. Bush added. Some additional cuts in current expenditures might be needed. Without data on productivity increases, it was difficult to assess the appropriateness of wage increases. Nonetheless, with a low inflation rate of about 5 percent, she would have recommended keeping nominal wage increases lower than in the recent past, when they had been twice the inflation rate. It appeared from the staff representative's statement that the 1984 retroactive wage increase was 11.5 percent; she urged that wage increases in 1985 be much more modest and that consideration be given to compensating cuts in other expenditures not only for budgetary reasons, but because a reduction in the disparity between civil service and agricultural wages might encourage workers to remain on the farms.

The elimination of interest rate ceilings was gratifying, Ms. Bush remarked. However, according to Table 11 of the report on recent economic developments, deposit rates were still slightly negative in real terms as of June 30, 1984. With its small open economy, Grenada needed significantly positive real deposit rates in order to inhibit capital outflows. Allowing citizens to hold foreign currency deposits in local banks should be helpful in that respect, and she asked whether she was correct in assuming that rates on such deposits would be set by market forces at prevailing international rates.

The position of the external sector reflected the cumulative effects of past ambitious development plans, Ms. Bush observed. Imports remained high, approaching a projected 55 percent of GDP in 1984. Financing had been provided by substantial official grants. In future, emphasis should be placed on maintaining the existing infrastructure, and new projects requiring significant imports should be modest. Furthermore, additional improvements in the current account could be brought about by an adjustment in the exchange rate. The authorities were reportedly reluctant to support an adjustment in the exchange rate of the Eastern Caribbean dollar while they were undertaking a broad structural reform of the economy. She would suggest, however, that an exchange rate adjustment might underpin those structural reforms by making the farming of both export and import-substituting food crops more attractive. In addition, an exchange rate adjustment offsetting the 26.5 percent real appreciation of the East Caribbean dollar since 1980 could increase the competitiveness of Grenada's tourism industry and other nontraditional exports. Revitalization of the private sector was at the core of the authorities' economic philosophy; but private business could not compete on regional or world markets, and thus could not grow and provide employment, unless the exchange rate sent the appropriate price signals. She urged the authorities to press for a swift completion of the ECCB exchange rate study.

The liberalization of the foreign investment regime, including the elimination of the withholding tax on profit remittances and the removal of the surrender requirement for export earnings, should make Grenada an attractive locale for direct investment, Ms. Bush considered. Foreign capital could be expected to provide employment, thus facilitating the divestiture of the public enterprises. Finally, as equity inflows replaced borrowed capital, Grenada's debt profile should improve. Meanwhile, at a projected 19 percent of exports of goods and services in 1985, the debt service ratio was not high in comparison with that of many other countries, but it had increased rapidly and could easily become burdensome for such a small economy.

In conclusion, Ms. Bush remarked, she had emphasized the need for exchange rate adjustment and direct investment because Grenada's economy, while small, could nonetheless become more diversified, thus reducing the necessity to rely too heavily on any single source of foreign exchange. She supported the proposed decision.

The staff representative from the Western Hemisphere Department said that it would be difficult to quantify the impact of the tax reform until the pace and extent of its implementation became known. Much would depend on the approach of the new Government. Similarly, the possibility of generating some nonrecurrent revenue from the sale of public enterprises was also subject to decisions that remained to be taken by the new Government. Most of the public enterprises to be sold were unlikely to generate much revenue. The few important exceptions included the state commercial banks, which could be sold at a substantial profit, and the Grenada Beach Hotel, the sale of which would yield different amounts of revenue, depending on whether or not it was decided to sell both the land and the buildings, to lease the land and sell the buildings, or to retain both and enter into a contract to manage the hotel. It should be noted that the Grenada Beach Hotel was a very valuable property; the buildings alone were worth about US$5 million.

The exchange rate had had an adverse effect on the profit margins of most export industries, and in particular, of the producers of bananas, coconuts, and nutmeg, the three main agricultural exports of Grenada, the staff representative stated. If the exchange rate was adjusted, profit margins would increase and the increase in the incomes of the rural sector would have a beneficial effect on output. For instance, there had been a dramatic increase in the volume of exports of fruit and vegetables over the past three or four years, largely because of better profit margins; the unit value of those exports had not increased greatly. Nevertheless, even if the gap between remuneration in the rural and urban sectors could be reduced, it had to be borne in mind that there were other, noneconomic factors underlying the shortage of labor in agriculture. Educational and other social welfare facilities were not as well developed in the rural areas; in addition, labor unions were better organized in the urban areas and were therefore able to obtain larger wage increases.

The exchange rate study being conducted by the ECCB had been delayed by the slow process of gathering information, the staff representative explained. Data, particularly on the cost side, was difficult to obtain in many of the member countries. The staff of the Fund was helping the ECCB, which wanted to make a fairly thorough study that should be ready in the first half of 1985.

There was limited scope for achieving a better fiscal equilibrium by cutting expenditure, the staff representative observed, because most expenditures were fixed. Little could be done in the short term to reduce the debt service burden: payments arrears had to be settled, pension benefits were fixed commitments, and wages were hard to keep down. Furthermore, purchases of goods and services, in which specific cuts could theoretically be made, accounted for only about 20 percent of current expenditures. Although capital spending would fall from 1986 onward, as the investment program neared its end, the result was likely to be an increase in recurrent expenditures once projects were completed, the capital expenditures themselves having been largely financed externally.

Interest rates in Granada were much less negative than they had been in the past, the staff representative noted. The increase in the ceiling on lending rates should give the banks more flexibility. There was no ceiling on deposit rates, which were freely determined and were likely to be affected only indirectly by the ceiling on lending rates. At present, the demand for credit was not very high, and the liquidity position of the commercial banks had improved significantly following settlement by the Government, with foreign assistance, of certain balances due. As investment picked up and the demand for credit increased, the banks would have more incentive to offer higher deposit rates.

The measures adopted recently by the Government, including the liberalization of pricing policies, of import licensing requirements, and of the guidelines for investment, should improve the outlook for private sector investment, the staff representative from the Western Hemisphere Department said. Furthermore, those steps would bring Grenada's policies more in line with those of other countries in the area so that any relative disadvantages that it might have suffered from previously would disappear.

Mr. Zhang remarked that measures to fine-tune monetary, fiscal, and exchange rate policy were all well and good, but did the Government have a policy to deal with unemployment, which currently stood at about 27 percent?

The staff representative from the Western Hemisphere Department responded that the Government was well aware of the unemployment problem, which was why it had found it difficult to reduce the size of the public sector. To reduce expenditure on wages and salaries by cutting back the number of public employees would only exacerbate the problem. The solution envisaged was to adopt measures that would foster development of private sector activities so as to achieve an increase in GDP, permitting both the transfer of workers from the public to the private sector, and contributing to the absorption of existing unemployment. The increase in private sector investment needed to create new employment opportunities was not expected to be too substantial because the labor force in Grenada numbered only about 45,000. Therefore, a few new private sector industries--such as those in the manufacturing enclaves--producing goods for re-export had a significant potential to absorb additional labor; the competitive margin was less favorable in the agricultural sector.

Mr. Leonard said that there could be no doubt about the desirability of tax reform. The problem, to which there was no easy solution, was how to determine the revenue effects of different measures. There was very little room in Grenada's circumstances for either revenue losses or for expenditure cuts; rather, the need was for increased revenue and that might not be entirely consonant with the process of tax reform. Grenada was not alone in the world in facing that problem, but the Government had to be very careful not to take tax reform measures in haste that it would later repent.

There was also little doubt about Grenada's need for inflows of concessionary finance and grants, Mr. Leonard continued, but the prospects for such inflows were not very clear. Decisions on the inflow and terms of aid were outside the control of the Government--a question of particular relevance to small island economies, as he had mentioned on previous occasions.

Exchange rate policy was a matter of concern to all the countries belonging to the Organization of Eastern Caribbean States, Mr. Leonard noted. Opinions in the various islands were very divided on the merits of a change in the present exchange rate. It was clearly necessary to assess the possible consequences of a change and to explain it to all those concerned. For that reason, it was entirely appropriate to expedite as far as possible the study under way by the ECCB.

The issue of unemployment in Grenada raised by Mr. Zhang was a problem shared with other small tropical island economies, Mr. Leonard observed, and a number of valid points relating to it had been made in previous discussions in the Executive Board, including the seminar held on the problems of small tropical island economies (Seminar 84/4, 5/4/84). In tackling the problem, such economies needed, first, to be able to establish with greater certainty, and for a period of years ahead, what to expect by way of concessionary finance; expenditure limits could then be determined accordingly and compatible policies devised in other areas, including policies to attract investment from outside. Without greater certainty, reasonable development plans could not be made. The exchange rate also had to be better suited to the needs of such economies. Trading arrangements that gave favorable access to markets providing an outlet for the changed pattern of production would come about with the economic development of the islands. He realized that it was easy to prescribe policy principles in their broad terms; they were nonetheless valid and would have to be recognized in drawing up detailed operational measures.

The Chairman made the following summing up:

> Executive Directors were generally in agreement with the staff appraisal in the report for the 1984 Article IV consultation with Grenada.

Directors welcomed the initiatives taken by the authorities to simplify the complex system of government regulation of the economy and to rely increasingly on market mechanisms to determine resource allocation. In particular, they noted the decisions taken by the Government to eliminate price controls, to divest itself of certain public enterprises, to adopt more liberal guidelines for private investors, and to reduce import licensing requirements. Directors observed that increased private private sector investment would be of importance in promoting economic activity. The high unemployment existing at present in Grenada called for policies geared toward growth and the creation of opportunities for employment as one of the fundamental planks of a structural approach to economic policy, Directors believed.

At the same time, Directors expressed concern about the sharp increase in external debt and the recent deterioration in the public finances and the fiscal outlook for 1985. They noted that comprehensive tax reform as envisaged by the authorities, beneficial as it might be in stimulating private investment, could result in a substantial loss of revenue in the short term. That was worrisome in view of the increased expenditures stemming from the wage increase for 1984 to civil servants that had recently been granted by the authorities. Directors noted that the overall fiscal position was expected to weaken from a surplus equivalent to some 2 percent of GDP in 1984 to a deficit equivalent to more than 6 percent of GDP in 1985. They emphasized that moderation in wage increases was essential not only to the attainment of fiscal balance but to improve the competitiveness of the economy. They urged the authorities to consider ways to strengthen revenues, and to adopt as soon as possible a timetable for the implementation of the tax reform, the public enterprise divestment policy, and other fiscal policy measures needed to improve the budget outlook.

Note was taken of the recent increase in the ceiling on lending interest rates, which was seen as an important first step toward improving the allocation of credit and stimulating financial savings through its effect on deposit rates.

Directors expressed concern over the strong currency appreciation indicated by the rise in the real effective exchange rate in recent years and questioned the appropriateness of the present exchange rate. They were concerned about the structural implications of the exchange rate appreciation, especially in the agricultural sector. Directors noted the authorities' support for the study being undertaken by the East Caribbean Central Bank on the implications of its member countries' current exchange rate policy, and urged them to insist that the study be speeded up. They also urged the authorities to exercise the greatest caution with regard to foreign borrowing other than on concessionary terms.

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

The Executive Board then took the following decision:

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

2. Grenada applies a tax of 5 percent on most purchases of foreign exchange, which gives rise to a multiple currency practice. In view of the circumstances of Grenada, the Fund approves the retention by Grenada of the multiple currency practice resulting from the tax on foreign exchange purchases until June 30, 1985, or the completion of the next Article IV consultation, whichever is earlier.

Decision No. 7845-(84/168), adopted
November 21, 1984

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/167 (11/19/84) and EBM/84/168 (11/21/84).

3. EL SALVADOR - 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 completing the 1984 Article IV consultation with El Salvador to not later than December 5, 1984.

Decision No. 7846-(84/168), adopted
November 20, 1984

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/84/246 (11/19/84) is approved.

APPROVED: August 21, 1985

JOSEPH W. LANG, JR.
Acting Secretary