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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/49

3:00 p.m., March 18, 1983

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	M. K. Diallo, Temporary
	M. Hull, Temporary
	H. G. Schneider
	A. Le Lorier
R. D. Erb	
	S. R. Abiad, Temporary
	Jaafar A.
T. Hirao	T. Yamashita
	M. Casey
A. Kafka	
	W. Moerke, Temporary
	C. P. Caranicas
R. N. Malhotra	A. S. Jayawardena
	S. El-Khouri, Temporary
J. J. Polak	
	K. G. Morrell
G. Salehkhou	
	E. I. M. Mtei
	J. L. Feito
	A. Lindø
	Wang E.

J. W. Lang, Jr., Acting Secretary
J. A. Kay, Assistant

Also Present

Asian Department: P. R. Narvekar, Deputy Director; J. T. Boorman, S. Kashiwagi, S. M. Schadler. European Department: B. Christensen. Exchange and Trade Relations Department: D. K. Palmer, Deputy Director; S. Eken, M. Guitian, G. G. Johnson. Fiscal Affairs Department: V. Tanzi, Director; T. Yaganita. Legal Department: A. O. Liuksila, J. K. Oh. Research Department: C. F. Schwartz, Associate Director and Director of Adjustment Studies. Western Hemisphere Department: M. E. Hardy, H. E. Khor. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: A. A. Agah, J. R. N. Almeida, I. R. Panday. Assistants to Executive Directors: R. Bernardo, J. Bulloch, M. Camara, L. E. J. Coene, T. A. Connors, G. Ercel, M. J. Kooymans, P. Leeahtam, V. K. S. Nair, Y. Okubo, J. G. Pedersen, G. W. K. Pickering, A. Portas, J. Schuijer, D. I. S. Shaw, H. Suzuki, Zhang X.

1. JAPAN - 1982 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/83/48, 3/18/83) their consideration of the staff report for the 1982 Article IV consultation with Japan (SM/83/36, 2/18/83). They also had before them a report on recent economic developments in Japan (SM/83/17, 1/26/83).

The Chairman made the following summing up:

Directors commended the authorities for the good economic performance achieved in the face of severe recession in the rest of the industrial world. Maintaining economic growth at about 3 per cent and keeping unemployment low were creditable achievements in light of the harsh external realities. Continued progress in reducing inflation was also welcome.

The flexibility with which financial policies had been implemented was cited for its contribution to this successful performance. Directors commended the Japanese authorities for their continuing success with energy conservation, progress in which had contributed to a worldwide decline in oil consumption.

Directors noted the adjustments to monetary policy which had been made in the face of the weakening yen during 1982. A few Directors observed that a firmer course of action on this front at an earlier stage, including some additional increase in interest rates, would have helped to forestall the sharp decline in the yen which had occurred during 1982. A few Directors suggested that greater scope for action on the monetary side to defend the yen could have been provided by a more flexible fiscal stance. Most Directors thought that interest rates should not be permitted to decline until a firming trend of the yen had been established.

Most Directors supported the staff assessment of the authorities' conduct of fiscal policy. While many Directors shared the authorities' concern that little progress had been made in reducing the deficit, they thought that the flexibility that the authorities had shown in the face of large revenue shortfalls and sluggish private domestic demand during 1982 had been appropriate. Many Directors thought such flexibility, as recommended by the staff, might again be necessary in 1983, and encouraged the authorities to use fiscal policy, including the front-loading of public works expenditures, to help sustain and promote the recovery of the domestic economy. A few Directors thought that an even more aggressive stance of fiscal policy would be appropriate, but this was not the general line taken by the Board.

Directors commended the progress that the authorities had made in reversing the increasing share of central government expenditure in GNP. They noted, however, that in light of certain demographic factors that would increase spending for social welfare in the second half of the 1980s, continued progress might be more difficult. Directors welcomed the authorities' recent indication of flexibility, both in the pace at which the authorities would try to reduce the fiscal deficit and the associated policy options which would be considered. Some Directors expressed the view that over the medium term an adjustment in taxes might be necessary to reduce the large fiscal deficit, but other Directors noted that if the immediate need of the economy was for fiscal stimulus, it might be better achieved through reduced taxes so as not to compromise the substantial progress already made in reducing the growth of government expenditures.

There was general agreement among Directors on the desirability of a stronger yen. The prospects for further improvement in the current account, especially in light of the prospective oil price developments and the generally strong fundamentals underlying the performance of the Japanese economy, were not fully reflected in the current value of the yen. In this connection, the authorities' active intervention when the yen had been weakening during much of 1982 and their restraint in intervening against the strengthening yen later in the year, even at times of fairly sharp movements, were viewed as appropriate by the Directors who addressed this question. Some Directors supported the authorities' view that coordinated intervention against the weakening yen could have played a useful role. Directors emphasized the contribution a stronger yen could make in forestalling the spread of protectionism against Japan's exports.

Directors welcomed the importance that the Japanese authorities attach to trade liberalization as a means of improving efficiency and assisting the international adjustment process. They commended the authorities for the positive steps taken in the past 14 months to reduce barriers to imports, which leave Japan with the lowest tariffs on manufactured products among the major industrial countries. The authorities were urged to speed the legislative and regulatory revisions required for the full implementation of the recent measures. In recognition of the important contribution that Japan could make to reversing the protectionist tendencies currently plaguing the world economy, many Directors urged the authorities to continue their trade liberalization efforts, especially by encouraging agricultural imports and eliminating nontariff barriers. Several Directors shared the staff's concern about the proliferation of restrictions on Japan's exports.

Directors commended the authorities for their perseverance in liberalizing the capital markets, notwithstanding the sharp increase in capital outflows that had accompanied the weakening of the yen during much of 1982. Several Directors emphasized that further liberalization of domestic markets, especially as regards the array of instruments available to investors, and a further opening of public debt financing to foreign lenders would deepen Japan's money and capital markets and thus enhance their attractiveness.

Directors hoped that the improvement in domestic demand evident in 1982, albeit somewhat halting, would continue in 1983. Declining oil prices and the somewhat improved prospects for the U.S. economy would help. At the same time, however, the factors cited by the authorities as assisting the recovery--including a strengthening yen, reduced real domestic interest rates, and stronger world demand--had materialized only to a limited extent. In this environment, the authorities were urged to be cautious in implementing the restrictive budget planned for the coming year and to take action early to forestall the contractionary impact of that budget if signs of recovery in the private sector did not materialize soon.

Several Directors noted the continued high level of foreign direct investment by Japan. This was viewed as making a positive contribution both to reducing protectionist pressures and to spreading the technical advances evident in Japan's successful structural adjustment effort. These transfers reflected an appropriate counterpart to the current account surplus that had been recorded. Directors also commended the authorities for the steady increase in official development assistance, especially as it occurred at a time of austerity in domestic government spending. Several Directors encouraged the authorities to continue this policy, all the more so in view of the relatively low level of Japan's ODA relative to its GNP and its savings ratio. A few Directors hoped the authorities would reconsider the geographic distribution of aid flows.

Mr. Erb stated that at another time he would like to return to the issue of whether coordinated intervention would have made any difference to the stability of the exchange rate for the yen.

The Executive Directors concluded their discussion for the 1982 Article IV consultation with Japan.

2. ST. VINCENT AND THE GRENADINES - 1982 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1982 Article IV consultation with St. Vincent and the Grenadines (SM/83/20, 1/25/83). They also had before them a report on recent economic developments in St. Vincent and the Grenadines (SM/83/30, 2/10/83).

Mr. Casey made the following statement:

The following table draws together the most important recent trends and ratios in the economy of St. vincent and the Grenadines.

	1980	1981	Est. 1982	Proj. 1983
Real GDP (per cent change)	2.2	11.7	2.3	3.8
CPI (per cent change)	17.2	12.7	8.0	7.0
Deposit interest rate (per cent) 1/	3.5-4.5	3.5-5.5	3.5-5.5	3.5-5.5
Prime lending rate (per cent)	8-9	8-9	9-10	9-10
Net domestic assets (per cent change) 2/	15.4	6.1	22.8	5.7
Overall fiscal deficit (as per cent of GDP) 3/4/	-15.5	-20.5	-11.5	-14.8
Current BOP deficit (as per cent of GDP)	-17.9	-7.3	-15.3	-17.8
Debt service/exports (per cent)	1.1	1.4	2.7	3.4
Real effective exchange rate (per cent change; positive number means appreciation)	-1.8	8.6	7.3	...

1/ Time deposits, 6-12 months.
2/ Of the banking system. Percentage changes are in relation to liabilities to the private sector at the beginning of the period.
3/ Fiscal year ending June 30.
4/ Before external grants and concessional loans.

The sharp recovery in real GDP in 1981 after natural disasters in the two previous years slowed in 1982 because of drought and the sluggish state of the international tourist market. Growth prospects for 1983 are a little brighter, and unemployment is likely to fall below the current rate of about 20 per cent.

The inflation rate has come down steadily to single figures, reflecting international price developments, despite domestic wage pressures.

The overall fiscal deficit would be unacceptably large in relation to GDP were it not for external grants and soft loans, which reduce it to manageable proportions (-1.5 per cent of GDP projected for 1982/83). Government savings are, however, increasing as a result of various revenue measures--including a broad-based consumer tax--which offset civil service pay awards.

The Government is fully aware of the need to achieve larger surpluses in its current budget so as to contribute more of its own resources to investment. Additional external aid will also be required to finance the investment needs of the economy in the years ahead. The finances of most of the state enterprises and public utilities have also been improving, and major efforts are being made to reduce production costs in the sugar factory.

The rate of growth of domestic credit accelerated in 1982. The resulting liquidity squeeze, especially in the National Commercial Bank, is a problem to which the authorities are giving attention. Deposit interest rates are still on the low side despite the fall in the inflation rate. Lending rates are now, however, positive in real terms.

The current external deficit is expected to deteriorate further in 1983 but is expected to be covered by largely concessional capital inflows, and thus the external debt position remains relatively manageable. The remaining small overall deficit is expected to be financed by borrowing from the East Carribbean Currency Authority (ECCA). Membership in ECCA debars the authorities from unilateral action in regard to the exchange rate.

My authorities are in broad agreement with the staff appraisal and are grateful to the staff for their important technical work and valuable policy advice.

Mr. Hull stated that he was in general agreement with the staff appraisal, and that the economic performance of St. Vincent and the Grenadines seemed to have been fairly satisfactory, particularly taking into account the natural disasters of 1979/80. In former Article IV consultations, both his chair and the staff had urged St. Vincent and the Grenadines to accept the obligations of Article VIII; he commended the authorities for having done so.

Caribbean members of the Fund tended to be affected by the difficulties faced by many small island economies, including shortages of technical and managerial skills, and the heavy burden of installing and maintaining infrastructure, Mr. Hull continued. Moreover, for the East Caribbean members, the currency union to which they belonged reduced the array of policy instruments open to the authorities. He looked forward to the discussion of currency unions scheduled for May 1983; he would also be interested in the results of the promised study of small island economies, to see what conclusions for the formulation of adjustment programs could usefully be drawn. In passing, it would be helpful if more of the small island economies, including St. Vincent and the Grenadines, contributed to International Financial Statistics. The information that they could provide would be useful in testing any hypotheses that might be put forward in the forthcoming study.

By August 1982, the real effective value of the East Caribbean dollar, the currency of St. Vincent and the Grenadines, had appreciated by 18 per cent from the level of the previous two years, a circumstance that had probably affected export receipts from bananas, manufactured goods, and tourism, Mr. Hull noted. Similar problems had been experienced by other East Caribbean members. The current ECCA exchange rate had been pegged at EC$2.7 = US$1 for more than six years. During a number of Article IV consultations with individual East Caribbean member countries, the appropriateness of the exchange rate had been questioned; he wondered whether the staff could say whether it considered that a review of both the level of the East Caribbean dollar and the policy of pegging it to the U.S. dollar would be appropriate. He understood that it would not be easy to secure exchange rate adjustment in view of the institutional arrangements; for instance, exchange rate changes had to be made by unanimous vote of ECCA members. During the discussion on Fund surveillance for 1982, the United Kingdom had suggested the possibility of a joint Article IV consultation with all ECCA members; perhaps the idea was still worth pursuing.

Sound fiscal policies remained the key to sustainable growth, not least because they created an attractive climate for domestic and overseas investment, Mr. Hull maintained. Given the infrastructural needs of the economy, the significant public sector capital spending program required a firm approach to public sector finances; in the circumstances, the medium-term objective of achieving a surplus on the Government's current account was appropriate. It seemed desirable to avoid sharp increases in public sector wages beyond 1983, and to maintain revenue buoyancy. In general, he welcomed the introduction of broadbased tax measures, such as the Government's new turnover tax, which should yield revenues equivalent to 1.5 per cent of the gross domestic product for 1982/83. He wondered whether Mr. Casey or the staff would give their view on the desirability of a further shift to ad valorem taxes and duties.

With the exception of the sugar factory, most state enterprises had performed well, thanks to a flexible approach to pricing, Mr. Hull considered. Urgent attention should be paid to the financial position of the National Commercial Bank; the sale of the arrowroot stocks should help considerably.

As to monetary policy, Mr. Hull noted that real domestic deposit rates were substantially negative as well as being lower than elsewhere in the region. The rate should certainly be kept under review, and the removal or upward adjustment of interest rate ceilings might be helpful. However, it was not really clear what role interest rates played in such small island economies, especially within the East Caribbean area. The staff, in its currency unions paper, attributed the existence of the rather large spread to a variety of factors including diseconomies of scale, and government taxation of bank deposits, as in St. Vincent. But, there was a significant danger that as real savings and deposit rates rose, the real lending rate could become unduly high.

It was relevant to recall, Mr. Hull remarked, that following the volcano eruption of 1979 and the hurricane in 1980, St. Vincent had made a drawing under the Fund's policy on emergency assistance in November 1980. His authorities' general approach on such occasions was that they saw emergency support as being preparatory to a full-fledged Fund program; their expectation had been that St. Vincent would, in due course, agree on a program with the Fund.

If he understood the staff appraisal correctly, Mr. Hull observed, the only areas of serious concern to the staff were the sugar factory, the National Commercial Bank's liquidity position, and the appropriateness of the interest rate ceiling. The exchange rate was of course not a matter for the St. Vincent authorities alone. Although his authorities would have preferred a formally agreed program, the St. Vincent authorities had done well in the circumstances, and he hoped that they would continue their cautious policy stance.

Mr. Salehkhou stated that he had been impressed by the commendable efforts of a very small country to achieve growth and adjustment. Indeed, despite severely limited resources and a number of adverse exogenous factors ranging from natural disasters to the international recession, the economic performance of St. Vincent and the Grenadines had been generally satisfactory, due particularly to the authorities' appropriate investment strategy and generally prudent policies aimed at preserving the stable industrial environment of the economy and maintaining the growth of private investment.

However, Mr. Salehkhou went on, although significant progress had been achieved in dealing with inflation, which had been reduced to 8 per cent in 1982, the overall budget deficit and the current account deficit of the balance of payments had deteriorated further. Such developments should be of great concern to the authorities, even though large parts of both deficits had been covered by relatively generous external grants and concessionary foreign loans, which were helping to keep down the ratio of debt servicing to exports and service receipts.

In that connection, Mr. Salehkhou observed, the set of measures adopted by the authorities and aimed at increasing tax revenues and improving the finances of state enterprises and public utilities should result in a significant increase in public sector savings. On the other hand, he fully shared the authorities' attitude toward interest rates and exchange rate policies, and their preference for an adjustment that would be decided in cooperation with their East Caribbean partners, despite the adverse impact of low interest rates on deposits, and despite the recent effective appreciation of the currency, which had constrained the growth of exports and tourism.

The staff representative from the Western Hemisphere Department, replying to questions on the exchange rate, noted that a part of the work of transforming the East Caribbean Currency Authority into a central bank, a study of the level and peg of the exchange rate had been initiated by the East Caribbean countries. The Fund staff had been asked to make a technical contribution to the study: it had reviewed the real effective exchange rate and alternative pegs, and communicated a report to the East Caribbean Currency Authority. As to the idea of a joint consultation with ECCA member countries, the staff had not so far been able to organize such a consultation. Hitherto the Fund had been helped in its dealings with ECCA countries through a regional resident adviser stationed in the area, who had been able to achieve a degree of coordination. The staff would however try to bring about a joint consultation with the ECCA members as soon as feasible.

The staff shared Mr. Hull's opinion that the spread of ad valorem taxation might be one way of improving the tax structure of St. Vincent and the Grenadines, the staff representative went on. Indeed, the recently imposed sales tax could perhaps be improved by making it an ad valorem retail tax rather than merely a sales tax at the factory level.

On the question of interest rates, the staff representative noted that the Fund's study on interest rates in the East Caribbean area had not come to a clear conclusion as to whether an effort should be made to raise deposit rates, in particular because of the high spreads and the possible impact on the cost of bank credit. A year previously, the staff had been particularly concerned at the emergence of a large spread between interest rates in the East Caribbean and international rates. The subsequent fall in international rates had reduced that concern, so that the urgency of an initiative in that field was correspondingly less at present.

The Fund mission had raised the possibility of a Fund program, the staff representative from the Western Hemisphere Department explained. The authorities were aware that they could reach an agreement with the Fund without undue difficulty, but they had decided to keep their options open. It was therefore impossible to say whether there would be a program with St. Vincent and the Grenadines in the near future.

Mr. Casey remarked that the staff representative had answered all the questions raised by Executive Directors. He would convey their observations to his authorities in Kingstown.

The Chairman made the following summing up:

> Directors who spoke expressed broad support for the views stated in the appraisal of the staff report. They noted the relatively satisfactory growth performance of St. Vincent and the Grenadines in the last four years despite natural disasters and the recession in the industrial economies, and they commended the authorities for following generally prudent economic and financial policies and for creating a favorable environment for

private investment. Directors noted that the planned increases in the level of public investment depended crucially on policies to control public sector current expenditures, to strengthen public sector savings, and to improve implementation capacity. A further move toward ad valorem taxation was suggested. It was also remarked that the debt service ratio of St. Vincent and the Grenadines remained relatively manageable, and the hope was expressed that the country would continue to be able to attract adequate foreign resources on concessional terms.

Directors expressed concern over the liquidity position of the National Commercial Bank and hoped that the authorities would take remedial action. They encouraged the authorities to review exchange rate policies with the other members of the East Caribbean Currency Authority with a view to strengthening the balance of payments performance of the region in general and of St. Vincent and the Grenadines in particular. The idea of a joint Article IV consultation for ECCA member countries was put forward. Directors also urged the authorities to overhaul the interest rate ceiling system with a view to strengthening the incentive for saving.

APPROVED: August 23, 1983

LEO VAN HOUTVEN
Secretary