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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/69

10:00 a.m., May 13, 1983

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
	M. K. Diallo, Temporary
J. de Groote	H. G. Schneider
	G. Ercel, Temporary
	A. Le Lorier
A. Donoso	
R. D. Erb	
M. Finaish	S. R. Abiad, Temporary
	I. R. Panday, Temporary
	T. Yamashita
R. K. Joyce	M. Casey
	C. Robalino
G. Laske	
	C. P. Caranicas
	C. J. Batliwalla, Temporary
	J. E. Suraisry
	T. de Vries
	J. Schuijer, Temporary
	K. G. Morrell
	A. A. Agah, Temporary
	S. M. Hassan, Temporary
	J. L. Feito
J. Tvedt	
	C. Taylor
Zhang Z.	Wang E.

L. Van Houtven, Secretary
J. Corr, Assistant

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Also Present

B. Legarda, Consultant. African Department: S. M. Nsouli. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; M. Guitian. IMF Institute: S. Rodehn, Participant. Legal Department: W. E. Holder, J. Surr. Middle Eastern Department: A. S. Ray, Deputy Director; A. K. El Selehdar, Deputy Director; G. T. Abed, B. K. Short. Research Department: J. E. Blalock. Secretary's Department: A. P. Bhagwat. Western Hemisphere Department: S. T. Beza, Associate Director; J. Ferrân, E. Hernandez-Cata, Y. Horiguchi, L. R. Kenward, F. Pham. Bureau of Statistics: C. Briançon. Advisors to Executive Directors: S. E. Conrado, J. Delgadillo, S. El-Khouri, P. Kohnert. Assistants to Executive Directors: H. Alaoui-Abdallaoui, M. Camara, M. B. Chatah, T. A. Connors, I. Fridriksson, A. Halevi, P. Leeahtam, E. Portas, M. Z. M. Qureshi, Z. Shao, D. I. S. Shaw, H. Suzuki, M. Toro, J. C. Williams, A. Yasseri.

1. LEBANON - 1982 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1982 Article IV consultation with Lebanon (SM/83/32, 2/11/83). They also had before them a report on recent economic developments in Lebanon (SM/83/42, 3/3/83).

Mr. Finaish made the following statement:

For the past several years now, the basic problem afflicting the Lebanese economy has been a lack of security. The country has had to confront recurrent external aggression, especially in the south, and put up with widespread internal strife. Some periods of hostilities have been particularly violent, causing large-scale destruction of life and property. Partial recoveries made possible by the basic resilience of the economy in periods of relative calm have been repeatedly frustrated by a deterioration of the security situation.

The situation in Lebanon took a still more serious turn with the Israeli invasion of mid-1982. The invasion has caused considerable loss of life and damage to property and has produced economic destruction and dislocation on a vast scale. Tentative estimates of material destruction run into billions of dollars. The invasion has led to the occupation of a large part of Lebanese territory, which is having a further adverse impact on the economy, particularly on agriculture and trade.

Evidently, the task of economic management in these circumstances becomes a formidable one, and, with the loss of effective control over large areas of the country, a near-impossible one. To the extent possible, however, the Lebanese authorities have attempted to adapt their economic and financial policies to the changing circumstances. They have also sought technical assistance from several external sources, particularly the Fund. For some years, top priority has been accorded to the reconstruction and rehabilitation of the economy, a massive task made even more daunting by the events of 1982. The implementation of the authorities' reconstruction plans, however, has been severely hampered by the recurrent deterioration of the security situation. Thus, in addition to the availability of adequate financial resources, the success of any efforts in the future aimed at economic reconstruction, such as those to be embodied in the revised reconstruction plan being prepared in cooperation with the World Bank, will depend critically on the restoration of security and national authority in the country. The latter is the fundamental task for the period ahead.

Due to the weak security situation, only limited data on the Lebanese economy have become available in recent years. This has made the assessment of the economy's performance more

> difficult, and subject to a large margin of uncertainty. In the present staff report, the statistical content is weak, also owing to the exceptionally difficult situation in 1982 and the fact that the staff mission visited Beirut only a few weeks after the cessation of active hostilities. The existence of many important gaps in statistical information, relating both to the real sector and to the financial sector, is acknowledged at a number of points in the report. However, the Lebanese authorities consider that, given the limitations of data and the prevailing uncertainties surrounding the Lebanese economy, the report presents an acceptable account of economic conditions in 1982.

Mr. Suraisry stated that the Board's present discussion of Lebanon did not appear timely. He hoped that it would be possible to consider the Lebanese economy after the authorities had embarked on a full reconstruction program. Saudi Arabia had been trying to enable the authorities to initiate such a program in cooperation with friendly governments, the World Bank, and other institutions. Unfortunately, those efforts had been unsuccessful in the present circumstances, and there was thus little that the Board could discuss at the present meeting. It would not be logical and productive to discuss the economy of Lebanon until the Lebanese authorities took charge of all parts of the country; only then could possible recommendations by the Board be useful in helping Lebanon to embark on a solid economic course. Fortunately, the Lebanese economy had always shown remarkable resilience in the face of adverse conditions. He hoped that the Lebanese people would get back their country and that the Lebanese authorities would guide them to the right course of action.

Mr. Erb said that he supported the thrust of the staff appraisal and the proposed decision. The authorities had been conducting economic policy in a difficult environment since the mid-1970s, with 1982 having been particularly difficult. He agreed generally with the staff recommendations, which he interpreted as cautioning the authorities to follow prudent financial policies while pursuing rapid reconstruction.

Given the magnitude of Lebanon's problems, Mr. Erb continued, it might be tempting to view as unimportant the distortionary and budgetary effects of subsidies for certain loans and the prices of a number of goods. However, there were clear advantages in undertaking rebuilding and renewed growth at nonsubsidized interest rates. The staff had appropriately reminded Directors that interest rate subsidies for housing and industry could easily be diverted from the categories targeted.

It was clear that the Lebanese authorities would have to regain better control over the country, Mr. Erb commented, particularly over the ports of entry, in order for government revenues to be raised closer to expenditure levels. In the meantime, he agreed with the staff that the Government could take more positive steps, such as removing the subsidies for petroleum products and electricity rates. Finally, it was difficult to provide forceful policy judgments on exchange rate management in the present environment.

It was truly remarkable that the exchange and trade system had remained virtually free of restrictions despite the events of the past several years.

Miss Le Lorier remarked that, in such an exceptional and tragic situation, the Board should hesitate to, perhaps even refrain from, formulating comments or recommendations on economic and financial policies that might be considered irrelevant in the circumstances. The staff correctly acknowledged the difficulty of describing and analyzing macroeconomic developments, and the paramount importance of security conditions for the future of the economy. In that respect, it was worth considering whether it might have been appropriate in Lebanon's case to adhere to a two-year consultation cycle rather than an annual cycle. In practice, she was confident that the 1982 consultation had been helpful in preparing the way for further technical assistance from the Fund, a prospect that she warmly supported.

The ability of the Central Bank to manage the exchange rate and the resilience of the financial sector deserved Directors' admiration, Miss Le Lorier considered. The Lebanese pound had been one of the first freely floating currencies. The Central Bank had obviously become a master in the use of intervention techniques as well as of interest rate policies in a free exchange and trade system.

The analysis of the fiscal situation should, according to Article IV of the Articles of Agreement, "pay due regard to the circumstances of members," Miss Le Lorier went on. It appeared that the size of the fiscal deficit was not attributable to what would be considered in other circumstances an expansionary fiscal stance, but to the need to maintain the essential functions of the state. At the margin, it was possible to argue that further efforts could be made to reduce petroleum and electricity subsidies, for example. However, it was difficult to assess the degree of priority that such actions should receive: was the Board really in a position to weigh the economic consequences and financial effects? She understood that road transportation was the only practicable means of movement in Lebanon.

She fully subscribed to the view that getting reconstruction under way quickly and rehabilitating essential services should receive the highest priority, Miss Le Lorier stated. The intervention of the World Bank would be most valuable, and financial and technical aid by the international community would be greatly needed. Domestic macroeconomic policies could have a part to play, but she could not share the staff's view that credit subsidies aimed at benefiting individuals would be superfluous or counterproductive. There was little, if any, ground for suspecting that the Lebanese authorities would yield to the temptation to intervene unnecessarily in economic decisions. On the other hand, the level of interest rates was constrained by external considerations, and it might prove to be an obstacle to the reconstruction process. More important, war damage compensation was a basic right of individuals. She did not believe that the Fund had criticized European countries for undertaking such compensation after World War II. Finally, she was confident that the Lebanese authorities had the ability to carry out the task of managing economic recovery once the opportunity to do so was given to them.

Mr. de Groote stated that he was hesitant to offer observations on the Lebanese economy at present. The political situation was very fragile and the Government had not restored full sovereignty over its territory. Consequently, data on the economy were scarce; the staff had sometimes had to refer back to data for 1980. In such circumstances, he was not convinced that an Article IV consultation was particularly fruitful. It might be useful to wait until the political issues were resolved.

The Fund could not play a helpful role at present, Mr. de Groote considered. The existing uncertainty and instability made it difficult to arrive at a proper judgment about the economy; the basic problems were political in origin and would not respond to economic solutions. It might have been better if the Board had been able to consider a "preconsultation" document for information, a document that would have contained credible explanations of the problems of the Lebanese economy without having the status of an Article IV consultation paper. More generally, was there a means of handling such cases within the Fund's procedures? Could the Board be informed of developments in a member country without giving to such information the formal status of an Article IV consultation, which had a strict legal definition? If so, when the political situation in Lebanon became clear, the Fund should become involved, but without having to undertake another consultation.

The problems of comprehensive reconstruction and economic development could not be addressed until security was restored, Mr. de Groote continued. The total cost of reconstruction was estimated at about $15 billion over the coming five to eight years. The Lebanese economy would need significant amounts of resources in addition to the resources required for the basic projects of public sector reconstruction and economic development, since the savings capacity of the country was limited. The staff hoped that about 75 per cent of the program might be financed from abroad. It would be extremely important for all those interested in the recovery of Lebanon, and for the Fund, to obtain information on the financing possibilities once the situation allowed; an appropriate document should be circulated to the Board at that time.

Based on the limited data available on the Lebanese economy, Table IV of SM/83/42 indicated that the 1983 budget envisaged a large, about fourfold, increase in customs duties, Mr. de Groote noted. In view of the estimated import data, such an increase appeared unrealistic in the absence of other new revenue measures; the whole question would have to be reviewed when circumstances allowed.

Until midway through 1982, residents had been encouraged to hold foreign currency receipts as foreign currency deposits in domestic banks, Mr. de Groote added. Between the end of May 1982 and November 1982, the share of foreign currency deposits had declined from 39 per cent to 27 per cent. The staff had explained that that development had been the result of a change in confidence that had caused a rapid appreciation of the Lebanese pound, and of a narrowing of interest rate differential in favor of the pound, resulting in the conversion of foreign currency deposits into pounds. However, in view of the armed conflict and the accompanying deterioration in security, could the rate of growth of the money supply be attributed to additional factors? For example, had the foreign currency deposits held by Lebanese residents outside the country shown any tendency to increase? In conclusion, Lebanon's prospects depended on political factors, especially political stability. Without stability, the authorities would have no room for maneuver as they attempted to manage the economy.

Mr. Caranicas said that he agreed with Mr. de Groote's observations. The 1982 Article IV consultation with Lebanon could perhaps have been postponed, and the Board might have been provided with a paper describing the present conditions in Lebanon, a country largely occupied by foreign powers. He also agreed with Mr. Suraisry that it was difficult to reach any conclusions about economic developments in the present circumstances. The political problems had to be tackled before the Fund could analyze Lebanon's economic situation in a meaningful way.

Would it be possible to provide Directors with information on the status of the foreign assistance needed to finance the reconstruction plan, Mr. Caranicas asked. Specifically, what stage had been reached by the consortium of aid donors sponsored by the World Bank? Second, had the appreciation of the Lebanese pound been reversed, or simply halted, in recent months? If not, what were the implications for the country's balance of payments? His authorities were watching the situation in Lebanon closely, and they stood ready to support fully any efforts that the international community might undertake to assist in reconstructing and rehabilitating the country.

Mr. Agah observed that the question of the need for the present consultation and its usefulness either to the Fund or to the member had been raised by Directors. It was in line with the general conclusions of the previous review of surveillance policies that consultations with small countries such as Lebanon need not be on a 12-month cycle. Furthermore, an appropriate assessment of Lebanon's economic prospects and policies could not be undertaken while the country was still under the unfortunate consequences of the Israeli invasion and occupation, and while those with whom the consultations had been conducted were in no position to establish or implement economic policy. Thus, under the present circumstances, his chair strongly considered that an examination of Lebanon's economic policies and prospects was neither appropriate nor valid.

Mr. de Vries commented that the usefulness of a consultation with Lebanon in the present circumstances was open to judgment. The papers prepared by the staff had been interesting, and they had indicated the impressive resilience of the Lebanese economy. Nevertheless, it might have been better to postpone a formal discussion.

The Lebanese Government had a tradition of following relatively laissez-faire policies, Mr. de Vries continued. However, in the present situation, it believed that special attention had to be given to housing. The staff had issued a warning in that regard, but it was questionable whether such a warning was appropriate. The whole attitude of the Government was cautious, taking into account the economic realities. If the authorities believed that housing for low-income Lebanese demanded priority in the present situation, it was not clear that advice to "go slow" was appropriate.

There appeared to be inconsistencies between statements in the body of SM/83/32 and statements in the staff appraisal with regard to the loss of customs duties, Mr. de Vries commented. In the main section of the paper, the staff had stated that:

> The opening of the southern border to imports from Israel and from other countries via Israel had displaced imports through other illegal ports but with no additional deterioration in customs receipts.

In the appraisal, however, the staff gave the impression that there had been an additional loss of customs duties. It should be noted that, according to the documents before the Directors, no additional loss of customs duties had in fact occurred.

The Deputy Director from the Middle Eastern Department remarked that the staff had taken the position that the Lebanese authorities should be particularly careful in providing interest rate subsidies, even for low-income housing, for two reasons. First, the Lebanese private sector had frequently responded vigorously, despite adverse circumstances. Second, the staff had believed that, if the Lebanese authorities were convinced that an interest rate subsidy was appropriate, they should make sure that the beneficiaries were low-income people in need of housing, and not developers.

Commenting on the question of customs duties, the Deputy Director remarked that the amount projected in the 1983 budget was high, about four times the amount collected in 1982. The budget figure assumed that the situation would return to normal--i.e., that the Government would control the ports--which had not held true since 1975, although from time to time some of the ports had come under government control. Recently, the southern border had been completely open, and the Government had not been able to collect any duties on the goods coming in from that direction. Therefore, the projection could be considered optimistic; but the staff accepted the authorities' judgment as reasonable, on the assumption that the situation returned to normal. The staff did not believe that it had treated the question of customs duties differently in different sections of SM/83/32. It had restated the authorities' assessment that there had been no additional significant loss of customs duties, or at least that it was difficult to judge whether there had been an additional loss, because goods had been coming in through illegal ports anyway. The authorities' concern about the continued importation of goods across the southern border related to the long run, rather than the short run. As indicated by their budget projections, they hoped to bring all ports under their control before long.

Referring to factors affecting the money supply, the Deputy Director observed that the main impetus to the monetary expansion in the last six months of 1982 had come from the increase in credit to the Government. Although Lebanese residents' deposits denominated in foreign currency with local banks had decreased in that period, their time and savings deposits denominated in Lebanese pounds had increased by more than twice as much. Those movements suggested that depositors had shifted from locally held foreign currency deposits into Lebanese pound deposits. As both categories of deposits were components of quasi-money, the shifts were partially offsetting. During the last four months of 1982, confidence had increased; the staff was unaware of any abnormal increase in Lebanese residents' deposits outside the country. In fact, the appreciation of the Lebanese pound in September-December 1982 suggested an inflow.

The upward movement of the Lebanese pound had slowed considerably in recent months, the Deputy Director from the Middle Eastern Department added. Since the issuance of SM/83/32, there had been a slight further appreciation, but its effect on the balance of payments would probably be marginal. The main impact on the balance of payments would arise from the reconstruction effort and its financing. A meeting of the potential aid donors was scheduled for July 1983, but its outcome could not be guessed at the moment. The Lebanese authorities expected that about 75 per cent of the total of $15 billion required over a period of eight years would be provided by external sources, with the remainder of the financing being supplied by the domestic economy.

Mr. Erb remarked that he was concerned about the suggestion made by some Directors that an Article IV consultation might not have been appropriate in Lebanon's case. Many members of the Fund were faced with unstable political conditions as a result of either internal or external factors, and it was unclear in what circumstances the Fund should forgo its responsibility to conduct consultations with such members. He invited the staff to comment.

The Deputy Director from the Exchange and Trade Relations Department observed that an alternative to an Article IV consultation would have been to send a report to the Executive Board for information. However, the staff had judged that the Lebanese authorities had found the discussions helpful, although necessarily limited in the circumstances. It had also believed that the authorities expected to benefit from the views of Directors provided in the process of an Article IV consultation as they tried to cope with their various economic problems.

Mr. de Groote commented that a serious issue of principle had been raised. Directors would agree that it had been extremely useful to have a staff mission in Lebanon to prepare the ground for further appropriate financial involvement of the Fund in the country. The Fund had an important responsibility toward Lebanon in the present circumstances. However, there was a legal question to consider: Article IV consultations were intended to have a specific purpose, i.e., to make recommendations to a member country on the basis of the Fund's jurisdiction over exchange rates and, indirectly, over economic policy. It might be possible to make such recommendations, even in countries suffering from revolutions or wars, if the authorities in the countries concerned were in a position to implement economic policies to a reasonable degree. The Board had taken that approach in previous cases. However, it was not reasonable to address economic policy recommendations to the Lebanese authorities in the present circumstances. For that reason, it seemed inappropriate to conclude the present Article IV consultation; he did not believe that there was a legal obligation to do so. Perhaps Directors could take note of the comments made in discussion, the information provided by the staff, and the statement by Mr. Finaish, but without going further until additional information became available.

Mr. Erb wondered whether in previous cases of a similar nature the request for an Article IV consultation had been initiated by the Fund or by the member. More generally, if a member indicated that it would prefer to delay an Article IV consultation, what degree of flexibility was permitted? Alternatively, if a country wished to hold an Article IV consultation, but the Fund wished to postpone it, how was such a decision arrived at?

Miss Le Lorier remarked that the recommendations in the staff appraisal seemed more appropriate to the conclusion of a technical assistance mission than to an Article IV consultation. For example, the staff had indicated that its main concern with regard to interest rate subsidies was how such a policy would be implemented in practice, a fairly technical point. The only conclusion of the staff on exchange rate policy was that there was little to add to the actions taken by the Lebanese authorities. Therefore, the report could be regarded as preparatory to the provision of further technical assistance by the Fund, rather than as a standard Article IV consultation report. She fully supported the remarks made by Mr. de Groote, in particular that a summing up would be inappropriate in the circumstances.

Mr. Caranicas observed that perhaps much of the present discussion could have been avoided, if the consultations with the Lebanese authorities had taken place at an 18-month or two-year interval instead of in accordance with the standard 12-month cycle. A similar awkward situation had arisen in Cyprus, where the Fund had undertaken a consultation when almost half the territory had been under occupation by a foreign power, resulting in a lack of fiscal control by the authorities. However, now that the consultation process had begun, the only practicable solution was to conclude it in the usual way.

Mr. Finaish said that a number of Directors had privately expressed to him their concerns about the timeliness of the consultation with Lebanon. They had pointed out that there had been many exceptions to the

12-month cycle for other Fund members, including some industrial countries, and they had wondered why, in the absence of adequate data and meaningful policy recommendations, the discussions with Lebanon had had to be conducted on the basis of a rigid timetable. It was difficult to dismiss the argument that the unusual circumstances of Lebanon warranted a more flexible approach to the timing of those discussions. He had, indeed, sought to have the Board discussion postponed until additional information was available and the overall situation of the country became clearer. However, in light of the issuance of the staff report, as well as the uncertainty about the availability of more information in the near future, the discussion could not be postponed indefinitely.

In the circumstances, Mr. Finaish continued, it had been difficult to formulate an appropriate statement for the Board's consideration. Simply to have addressed the policy issues raised in the staff report, such as the appropriateness of interest rate subsidies or the degree of intervention of the Central Bank in the foreign exchange market, would have run the risk of appearing to be preoccupied with issues irrelevant to the major concerns of the Government at a time when it was attempting to exercise its basic authority throughout the country. On the other hand, to have addressed issues relevant to those major concerns would have run the risk of making what some members of the Board might consider a political statement. He did not see his statement as political. It was simply a fact that security was the major problem facing the Government, and that it had to be solved before other issues could be meaningfully addressed.

The question of reconstruction and how to finance it had been raised by Directors, Mr. Finaish noted. In that regard, he welcomed Miss Le Lorier's remarks on the situation in Europe after World War II. A great many issues needed to be addressed, but the willingness of the Lebanese authorities and the people of Lebanon, known for their ability and enterprise, was not in question. The authorities would welcome whatever external assistance was possible in the massive task that they faced. He believed that the United States in particular would have a strong role to play, if only for moral reasons. An article in the New York Times of August 25, 1982 by Mr. George Ball, the former Under-Secretary of State of the United States, well expressed the views of a substantial portion of American opinion. Mr. Ball had written, in part:

> Huge amounts of outside aid will be needed and, under international law, Israel, as the aggressor, would normally be expected to pay the bill. Arab states might have been considered liable for damages had they come to the defense of the P.L.O. But they did not. The Lebanese civilians did not ask the Israelis to destroy their houses and kill their children, and it would be immoral if they were left with no compensation....
>
> We [in the United States] should provide ample help for the Lebanese people. In the name of logic and justice, we should deduct the cost of that help from our annual subsidy to Israel.

> That subsidy is large enough to help materially with Lebanon's reconstruction. For the past several years, it has amounted to almost one fourth of our total foreign aid which, for a country with a population less than that of Detroit and only one-tenth of 1 per cent of the world population, suggests some distortion of values. Our Government's annual assistance to Israel amounts to roughly $2.7 billion--$750 per head for Israel's 3.5 million people....

Of course, other countries had an interest in, and a responsibility for, providing assistance to Lebanon; a number of them, particularly Arab countries, had already been doing so.

Commenting on the point raised by Mr. de Vries about importation of goods across the southern border, Mr. Finaish remarked that while it was true that other ports of entry were not totally controlled by the authorities, the flow of imports through the southern border was particularly troublesome. Not only did that flow occur at a time when it was hoped that the Government's control over the Beirut port would increase customs duties significantly, but it also constituted a disruptive factor in the flow of exports to some neighboring countries.

The Acting Chairman, commenting on the question of whether or not to conclude the Article IV consultation, stated that Article IV provided that members should consult with the Fund when requested by the Fund. The procedures for surveillance in Executive Board Decision No. 5392-(77/63), adopted April 29, 1977, stated that:

> Members shall consult with the Fund regularly under Article IV. The consultations under Article IV shall comprehend the regular consultations under Articles VIII and XIV. In principle such consultations shall take place annually and shall include consideration of the observance by members of the principles set forth above i.e., the principles for Fund surveillance over exchnange rate policies, as well as of a member's obligations under Article IV, Section 1. Not later than three months after the termination of discussion between the member and the staff, the Executive Board shall reach conclusions and thereby complete the consultation under Article IV.

Conclusions, as referred to in that passage, normally took the form of the summing up by the Chairman or the Acting Chairman, the Acting Chairman observed. If conclusions were not reached, the Article IV consultation would not have been completed. While there was room for discretion with regard to the timing of consultations, the consultations could not be postponed indefinitely, except under very special circumstances. The Board had had an extensive discussion of surveillance policy at EBM/83/55 (4/7/83), including the question of the frequency of Article IV consultations, a question that had been dealt with at length in the Chairman's summing up. Directors had generally agreed that a stricter approach to the scheduling of consultations should be followed, which implied, for the large majority of members, a 12-month cycle. The one exception noted by Directors was a situation of military hostilities. If the Board failed to adhere to the practice begun in March of reaching an understanding on the occasion of each Article IV consultation on the timing of the subsequent consultation, there was a grave risk of allowing the re-emergence of a situation in which consultations were allowed to be delayed with relative ease. While the Fund might not be in a position to give the Lebanese authorities very specific advice on, for example, the exchange rate, such a situation did not apply to Lebanon alone. The issue was, therefore, a wider one.

Miss Le Lorier said that she had not intended to imply that the Fund had no specific commendations to make with regard to Lebanon's exchange rate policy. Indeed, the staff had commented favorably on the Central Bank's handling of the exchange rate and its reserve management. However, the other parts of the staff's appraisal, dealing with interest rate subsidies and the like, were more in the nature of technical assistance advice.

Mr. de Vries commented that the situation was complex; Directors should pay particular attention to the views of the Executive Director concerned. As he understood those views, Mr. Finaish had been concerned about the frequency of consultations with Lebanon--it appeared as though only eight months had elapsed between the 1981 and the 1982 consultations. If that was so, Mr. Finaish's concerns were justified. He also agreed with Mr. Finaish that, since the consultation process had been begun, it would be preferable to conclude it in the usual fashion.

The Acting Chairman noted that discussions had been held by the staff with the Lebanese authorities in Beirut between December 11 and 16, 1981; the Executive Board had discussed the consultation report on March 22, 1982; the most recent discussions had taken place between December 15 and 20, 1982. Thus, the 12-month cycle had been observed.

Mr. Caranicas said that the Board should conclude the consultation in the usual way, and adopt the proposed decision. However, the experience should serve as a lesson that the annual cycle of consultations need not be strictly adhered to when the situation was as confused as in present-day Lebanon.

Mr. de Groote wondered whether it would be acceptable to the Lebanese authorities for the Board to state that it had taken note of the important information that it had received, that Directors had exchanged views on the situation in Lebanon, and that they had expressed the wish that the consultation should be concluded when political circumstances permitted.

Mr. Finaish remarked that, when he had referred to the apparent untimeliness of the consultations with Lebanon, he had been expressing the views of Directors who had spoken to him privately. He appreciated the views expressed by Mr. de Groote and others. However, he believed that his authorities' preference would be for the discussion taking place to be concluded in the usual fashion. The unusual step of adjourning the discussion without a conclusion could reflect unfavorably on the Lebanese authorities.

Mr. Erb said that he agreed with Mr. Finaish.

Mr. de Groote stated that he could accept the line of action proposed by Mr. Finaish as the Executive Director elected by Lebanon. Nevertheless, he believed that an exception should have been made to the formal schedule of consultations; the Board would then have been able to provide the Lebanese authorities with appropriate policy recommendation at a time, unlike the present, when they would be in a position to implement them. He stressed his strong support for continued cooperation between the Fund and Lebanon, including financial assistance from the Fund. But it would not help Lebanon, or other countries, to transform the Article IV consultations into purposeless formalities. There could be no doubt that other countries would seek to delay the consultation cycle, and they might well find good reasons for doing so. Common sense, as well as Fund policies and procedures, had to be applied to the particular circumstances.

The Acting Chairman then made the following summing up:

Executive Directors expressed sympathy for the human suffering and material destruction that Lebanon had endured in 1982. Hope was expressed that the security situation would improve so that the authorities would be able to undertake in full the vital task of rebuilding.

Directors were impressed by the high resilience of the Lebanese economy, and they observed with approval that the authorities put a high priority on drawing up a comprehensive reconstruction program and promptly putting it into effect in cooperation with friendly governments, the World Bank, and other international institutions. Directors believed that so far the authorities had managed a difficult financial situation capably. Nevertheless, they expressed some concern over continued large budget deficits, and it was noted that the reconstruction plan would place further demands on the budget. While realizing the difficulties of increasing revenues until the Government exercised full control over all parts of the territory, including the ports, Directors indicated support for selective measures to improve the budget situation.

Recognizing that the Bank of Lebanon had faced a difficult task in slowing the sharp appreciation of the Lebanese pound in the latter half of 1982, Directors commended the authorities on their exchange rate policy and management. Directors observed with approval that the authorities had succeeded in maintaining an exchange system virtually free of restrictions despite Lebanon's many difficulties.

Directors suggested that, consistent with the existing guidelines, a flexible approach should be taken toward the timing of the next Article IV consultation with Lebanon, and that the Fund should be ready to play an appropriate part in advising on the macroeconomic policy framework for future reconstruction.

Miss Le Lorier suggested that paragraph 2 of the proposed decision should be amended to reflect the statement in the report on recent economic developments that Lebanon was in fact in the course of terminating the outstanding bilateral payments agreement with a Fund member.

The Executive Directors, turning to the proposed decision, accepted the amendment put forward by Miss Le Lorier and took the following decision:

1. The Fund takes this decision in concluding the 1982 Article XIV consultation with Lebanon in light of the 1982 Article IV consultation with Lebanon conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Lebanon maintains an exchange system which is virtually free of restrictions on payments and transfers for current international transactions and is in the process of terminating the outstanding bilateral payments agreement with a Fund member.

Decision No. 7396-(83/69), adopted
May 13, 1983

2. BAHAMAS - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with the Bahamas (SM/83/64, 4/20/83; and Cor. 1, 5/9/83). They also had before them a report on recent economic developments in the Bahamas (SM/83/65, 4/29/83).

Mr. Joyce made the following statement:

My authorities agree in general with the staff's assessment of the performance of the Bahamian economy in 1982 and the prospects for 1983.

While economic performance continued to be affected by adverse world economic conditions, overall economic activity in the Bahamas in 1982 improved compared with the previous year. Tourist activity grew, construction on two major tourist projects moved ahead, and manufacturing sector exports increased markedly. Moreover, the rate of price and wage increases also slowed, the current external account showed substantial improvement, and, despite a substantial decrease in long-term capital inflows, there was also an increase in net official reserves.

My authorities agree with the staff conclusion that a further moderate pickup in tourism can be expected in 1983 and that this, in turn, should lead to a further increase in overall economic activity. However, because the volume of imports is directly affected by the level of tourist activity, the current account of the balance of payments will again likely show a modest deficit. The pickup in economic activity will also increase tax revenues, as will the new revenue measures announced by the Government in the budget in December 1982. In the budget, the Minister of Finance announced increases in customs duties on gasoline, diesel fuel, tobacco products, and a number of consumer items. In addition, the Government increased the departure tax, raised the fees payable by banks and trust companies, and increased motor vehicle licenses and fees. The Minister also announced his intention to adjust real property taxes to encourage further development. On the expenditure side, it is intended to limit the growth in the Government's current expenditures to 6.5 per cent in 1983. However, the reductions in current expenditure would be more than offset by proposed increased capital expenditures, and the Government's budgeted deficit for 1983, at B$33 million, would be higher than in 1982. In the event, the actual fiscal outturn in 1983 may be somewhat better.

There are two important points on which my authorities view matters somewhat more optimistically than the staff. These relate to (1) the gross financing requirements of the Government in 1983 and the steps needed to bridge any gap that may emerge, and (2) the staff's views about the medium-term outlook and the fiscal position of the Government.

There is fundamental agreement that the gross financing requirement of the Government in 1983 will almost inevitably be large. As the report points out, this is mainly because of the need to complete the Hotel Corporation's current investment program. The staff doubts whether the financing envisaged for 1983 will be sufficient to cover these requirements. In its view, the Government should increase tax collections, make further efforts to curb current expenditures, and, in particular, ensure that the increase in government salaries is restrained.

Let me say at the outset that the Government recognizes that there has been a sharp increase in the public sector external debt in the past few years and that it would be unwise to contemplate further substantial increases in borrowing at home or abroad in order to finance government deficits. The Government has already announced additional tax and expenditure measures in the December budget. In addition, further increases in the fees charged by public corporations have also been authorized. While the authorities intend to take steps to improve revenue collections, they do not believe that it is appropriate to bring down a supplementary budget at this time imposing additional taxes.

They recognize that current financing plans may not be sufficient to cover all the financial requirements envisaged. However, they believe that, with the pickup in tourism, revenues in fact may increase much faster than envisaged at the time of the budget. This, coupled with continued restraints on current expenditures as well as the delays that often attend the implementation of capital programs, may well reduce the actual financial requirements to more manageable levels. Indeed, as the staff reports, the Government has indicated that, if this does not occur, it is ready to restrict capital investment further, if necessary, to eliminate any financing gap. My authorities do not consider that this is likely to delay priority investments.

With respect to the medium-term outlook, it is the staff's view that the Government's fiscal position could come under pressure by 1986/87 when payments begin to be made on the B$150 million loan financing the hotel investment program. My authorities do not necessarily disagree with this prognosis, although much will depend, of course, upon the success of the new hotel complex and the revenues it generates. My authorities believe it is too early to reach a conclusion on whether significant tightening in the fiscal position will be called for. They will, of course, continue to look to ways of restructuring the revenue base and they will wish to persist in efforts to exercise expenditure restraint on both current and capital account. They welcome the staff's conclusion that the current investment plans of the Government and the public corporations appear to be consistent with the country's development priority.

Finally, I would like to reiterate the Government's view, which I note is shared by the staff, on the desirability of maintaining parity between the Bahamian dollar and the U.S. dollar. Pursuit of such an objective imposes certain limits on the authorities' freedom of action and it is important that the cost-price situation in the Bahamas not be permitted to deteriorate relative to that in the United States. My authorities also agree that the Central Bank has little room to expand credit to the public sector in 1983 and that, given the current liquidity position of the banking sector, it is important to ensure an appropriate differential between the Bahamian and U.S. dollar interest rates. The Central Bank, of course, is bearing this in mind in fixing the bank rate, in deciding on changes in the prime rate, and in setting limits on deposit rates.

I would like to thank the staff for the thorough way in which these Article IV consultations were conducted, the thoughtful suggestions put forward, and the useful attempt to cast the discussions against the background of possible scenarios for the medium term.

Mr. Taylor observed that the Bahamas had weathered the inclement effects of the international recession better than many small island economies dependent on one or two primary commodities. Earnings from tourism had recovered modestly in 1982, and receipts from financial services had held up relatively well. Prospects for 1983 also looked moderately good: output seemed set to recover slightly, and inflation had come down a good deal. However, although the situation appeared relatively problem free at the moment, there were several policy issues that merited consideration.

First, in the fiscal area, Mr. Taylor continued, the government accounts had moved sharply into a sizable overall deficit in the previous two years, especially if government lending to the public corporations was included. Some, but not all, of the movement had been associated with the intensification of the major investment projects being undertaken by the Hotel Corporation, due to be completed in 1983. The staff judged that problems in that regard were primarily longer term; it expected that the Government's financial position would improve temporarily at the end of 1983 if not before, but it was worried about the position in 1986-87, when payments to amortize the public sector's recently enlarged foreign currency debt would peak.

The problem could be dealt with in a slightly different way, Mr. Taylor commented. The authorities would be well advised to take firm action at once to resist intensification of the fiscal pressures that seemed to have been emerging not only in relation to the development program, but in other areas of the public sector. The need for tighter expenditure constraints should be stressed; such an approach should play the major role in fiscal correction, with efforts being concentrated particularly on restraining recurrent expenditures, especially wages, and on confining investment to the most cost-effective projects. There might be a need for improvement in the quality of project assessment in the parastatal sector, and there was probably considerable scope for reviewing the internal cost and pricing structure of the parastatal organizations in order to improve their efficiency and to reduce government support. He agreed with the staff that there was a need for rapid authorization of price adjustments by the parastatal corporations.

Better wage restraint should be a high priority, Mr. Taylor considered, since wage increases in most sectors appeared to have been running uncomfortably ahead of inflation. That development was especially worrying if, as appeared likely, unemployment was tending to rise. It seemed that the labor market in the Bahamas was not very responsive to market forces, and, in that situation, wage restraint in the public sector, in which the Government had direct influence, acquired special importance for the wider economy.

The staff's view that there was a need for a special effort at fiscal tightening in the mid-1980's was not entirely convincing, Mr. Taylor went on. It was open to question whether the heavy amortization payments at present scheduled for 1986-87 should be dealt with through a general revenue-raising effort, for example. If the hotel investments were expected to be productive, and if the debt service ratio remained at about 4-5 per cent, in such circumstances a rollover or prolongation of the debt maturities should be undertaken pending the achievement of the higher stream of earnings from the projects concerned. However, if the projects appeared to be turning out less well than expected, or if, for any reason, there was a weaker than expected long-term revival of tourism, the authorities might be forced to resort to additional revenue-raising measures within a year or two. He agreed with the staff that there was a need for extreme caution regarding further enlargement of the public sector's external debt at present.

Commenting on supply-side policies, Mr. Taylor welcomed the steps being taken to attract new private investments to the island and to diversify the economic base. What kind of incentives were being offered or contemplated in the new free trade zone, and did the authorities plan to create linkages between that effort and the activities of the important offshore banking sector?

The staff approved the established approach under which the Bahamian dollar was pegged at parity to the U.S. dollar, Mr. Taylor noted. The rationale for such a policy was understandable, given the close financial and trade ties with the United States, but, bearing in mind the views expressed by Directors recently on currency unions (Seminar 83/1, 5/4/83), was it the best approach for a small, separate, and specialized economy? To be feasible, the policy would require a high degree of monetary and financial discipline, as Mr. Joyce had stressed. He agreed that such discipline had generally been achieved in the past, and that consumer price increases had been relatively close to those in the United States over the long run, but the danger signals on the wage front indicated that it would be important to avoid opening up wage and price differentials with the U.S. economy in the future if the exchange rate parity was to survive. That parity had withstood wide interest rate differentials favoring the U.S. dollar, implying a considerable cost in terms of capital outflows.

In that regard, Mr. Taylor asked, did the reported balance of payments flows understate the true size of the capital outflows, some of which might be reflected in the relatively large item of net errors and omissions? Exchange controls on capital transactions had probably also played a part in contributing to the stability of the exchange rate. Allowing for all those considerations, emphasis should be given to the staff's recommendation that the authorities should pursue a more market-related interest rate policy as a means of augmenting domestic liquidity, thereby alleviating pressure on the international reserve position and on the financing of the fiscal position. He welcomed Mr. Joyce's statement to the effect that the authorities agreed that there was a need to ensure an appropriate differential between Bahamian and U.S. interest rates.

Mr. Suraisry remarked that the Bahamian economy had shown impressive resiliency in the previous year. Despite continued unfavorable conditions abroad, tourist earnings had picked up, helping to sustain activity in other sectors. The current account deficit had been significantly reduced, and the annual rate of inflation had come down to 4.5 per cent at the end of 1982. For the future, it was clearly vital that a small open economy like the Bahamas, heavily dependent on tourism, should maintain its competitive position. Cost/price developments had to be kept in line with those in the United States, given the close links between the two countries.

It was, therefore, encouraging, Mr. Suraisry considered, that the rate of increase in wages in most sectors, including the hotel industry, had moderated in 1982 and was expected to moderate further in 1983-84. He hoped that the authorities would maintain their firm stand on public sector wages; he invited the staff or Mr. Joyce to indicate whether the 7 per cent increase proposed for 1983 had been agreed by the public sector unions.

The main area of concern, Mr. Suraisry continued, was the Government's financial position, which had deteriorated markedly in recent years. The financing requirement had reached a historically high level, mainly as the result of the ambitious public investment programs. He agreed with the staff that further substantial foreign borrowing would not be appropriate. Such borrowing had risen sharply since 1980, and debt service payments were expected to increase in the medium term. The scope for borrowing from domestic sources also appeared limited. In such circumstances, he urged the authorities to press ahead with measures to correct the fiscal imbalance. They had already made encouraging moves in the right direction.

It would, however, be important to maintain the momentum in the medium term, Mr. Suraisry commented. Two thirds of the Government's tax revenues were accounted for by import duties, suggesting that there there might be room to broaden the tax base. Perhaps the staff or Mr. Joyce could provide additional information concerning the plans to restructure the tax system. On the expenditure side, the overall deficit of the public corporations had widened substantially since 1980, partly as the result of declining sales and delays in adjusting prices. The recent increases in water and electricity rates were, therefore, a welcome sign. More flexible pricing policies on the part of the public utilities could benefit the Government's financial situation considerably in the longer run.

The authorities should be commended for their broad-based efforts to diversify the economy, Mr. Suraisry stated. It was clear from SM/83/65 that the financial sector, both domestic and offshore, had become a significant source of revenue and of employment. The recent establishment of the Bahamas' Agricultural and Industrial Corporation, and the plans for a free trade zone, should strengthen the export-oriented manufacturing sector. Careful planning and a clear ordering of priorities would obviously be important requirements in the selection of investment projects. In short, the authorities appeared to be on the right track, and the economy seemed well placed to benefit from a recovery in the United States.

Mr. Erb said that he agreed with the remarks made by Mr. Taylor. It was essential for the authorities to monitor fiscal developments closely, and they should be encouraged to develop an appropriate set of contingency plans to deal with unforeseen adverse developments in that area. Even if fiscal performance turned out as expected, the authorities would continue to face a large gross financing requirement. The B$81 million that would need to be financed in addition to the budget deficit was of particular concern because the authorities' options appeared limited, and their plans to cover the gross financing requirement seemed ambitious. It would be imprudent to try to finance the B$33 million for which no specific financing plan had been advanced solely from the domestic banking system.

With regard to the medium-term outlook, Mr. Erb continued, the hotel project offered an example of an inappropriate approach to financing. It would have been preferable to finance the Hotel Corporation's investment program on a project financing basis, so that the debt would have been explicitly serviced from the cash flow of the project, rather than from general government revenues, as currently planned. It was ironic that if cash flow from the Hotel Corporation's investment was inadequate to service the debt, then the overall Bahamian economy was also likely to be facing difficulty, since both the economy and the hotel project depended on tourists' receipts to a great extent.

Mr. Laske stated that he endorsed the staff appraisal. Because of the close connection between Bahamian and U.S. trade and finance, and in particular because of the overwhelming importance of the United States to Bahamian tourism, the options available to the authorities to respond to swings in external developments were somewhat limited. Against that background, the authorities have been successful in managing the economy in 1982. The substantial decline in the rate of inflation, a deceleration in wage settlements, and the remarkable narrowing of the external current account deficit were especially noteworthy. Nevertheless, some areas of concern remained.

The public finances, as well as the external debt situation, had been deteriorating recently, Mr. Laske continued, largely because of the substantial public investment programs, which did not appear to be accompanied by adequately rising revenues or sufficient restraint in current expenditures. Nevertheless, in late 1982, considerable efforts had been made by the authorities, efforts that were expected to raise government savings significantly in 1983. It remained uncertain, however, whether those revenues would suffice in view of the financial assistance that the Hotel Corporation would need from the Government to complete its projects without delay. The government projections for tourism might turn out to be somewhat optimistic, and the high level of external debt made a continuation of borrowing from abroad inadvisable. Moreover, there was only limited scope for additional public sector borrowing from the domestic financial system without jeopardizing an adequate supply of credit to the private sector. In those circumstances, he agreed with the staff recommendation that efforts to increase tax revenues as well as to curb current expenditures should be further intensified. There also seems to be a case for a more flexible pricing policy by public corporations in order to respond better to cost developments.

Commenting on the fiscal position in the second half of the 1980s, Mr. Laske observed that pressures could be expected because of the sizable requirements to amortize the public sector's foreign debt. The staff and Mr. Joyce had provided clear evidence that the authorities had recognized the difficult situation that they were likely to face in a few years, and that they were determined to tackle it in an efficient and appropriate way.

It was the authorities' intention to maintain parity between the Bahamian dollar and the U.S. dollar, Mr. Laske noted. The pursuit of such an objective imposed restrictions on the use of monetary policy, and it deprived the Government of the Bahamas of the possibility of adjusting the exchange rate to maintain international competitiveness. It was, therefore, even more important that the competitive position of the economy, particularly in the tourism sector, should be maintained by keeping wage increases at reasonable levels and by pursuing a cautious fiscal policy. Although the current exchange rate policy might be appropriate under such circumstances, it would be useful if the staff or Mr. Joyce could provide more detailed information on the potential negative implications that a more flexible adjustment of the exchange rate would have on the Bahamian economy, or possibly on other economies in the region.

The staff representative from the Western Hemisphere Department recalled that Mr. Joyce had stated that the Bahamian authorities viewed two important points more optimistically than the staff, i.e., the financing requirement for 1983 and the longer-term prospects for public finances. However, it did not appear that there was fundamental disagreement between the Bahamian authorities and the staff with regard to either question. There was general agreement that the financing requirement for 1983 would be large, that it would not be appropriate to resort to substantial foreign borrowing to finance the government deficit, and that further measures would be required to reduce it. The Bahamian authorities did not believe that there was a need for new taxes at present. The staff had not, in fact, called for new taxes, although it would not have been opposed to such a proposal; rather, it had recommended an intensification of efforts to improve revenue collection and to curb current spending by the Government, particularly with regard to salaries. He understood that the Bahamian authorities agreed with those recommendations and that, for example, the collection of overdue real estate taxes had been pursued with energy, apparently with considerable success. If the efforts on the revenue side were maintained and intensified, and if considerable restraint were exercised with respect to government salaries, the financing gap in 1983 would be reduced to more manageable proportions. In the end, however, a cutback on investment plans would probably also be necessary. The authorities had repeatedly stated that they were prepared to reduce investment well below the budgeted level if necessary; they had taken that kind of action in the past in similar circumstances.

Commenting on the question of the public finances in the longer term, the staff representative noted that the assessment made by the staff had been based on projections prepared in the course of discussions with the

Bahamian authorities. The projections included a number of assumptions with regard to real economic growth, inflation, and other variables in the United States, and the staff had always emphasized that such longer-term projections contained a large margin of uncertainty, and that they simply represented a possible scenario. Although he believed that the assumptions had been reasonable, it was possible that developments could turn out to be more favorable than the staff had expected. For example, growth in the United States might be higher than the annual average of 3.5 per cent that the staff had assumed, so that the revenues of the Hotel Corporation might be higher than expected. However, although those outcomes were conceivable, it would be inappropriate to err on the side of optimism.

Up-to-date unemployment statistics were not yet available, the staff representative went on. The latest available figures, based on employment surveys in 1977 and 1979, indicated that unemployment had declined from 22 per cent in 1977 to 14 per cent in 1979. However, most Bahamian economists would agree that there had been an increase in unemployment since 1979; estimates ranged from 20 per cent to 26 per cent at present. On the question of wages, a 7 per cent increase in public sector wages had been proposed, as one Director had noted. Although formal agreement by the trade unions was not required, there had been a preliminary informal understanding by the two parties. The Government's proposal with regard to the free trade zone was still at an early stage of preparation. The intention was to bring into the Bahamas foreign companies that would be involved in light, labor-intensive manufacturing, oriented toward exports, particularly to the United States. However, it did not appear that firm commitments had yet been reached, and there had been no particular effort to link the free trade zone to the operations of the offshore financial institutions.

The Bahamian authorities believed that the existing fixed exchange rate between the U.S. dollar and the Bahamian dollar had a number of advantages for a country heavily dependent on tourism, the staff representative commented. More than 80 per cent of tourists were from the United States, and the fact the U.S. currency circulated side-by-side with the Bahamian dollar had obvious advantages. Furthermore, the Bahamian authorities believed that the existing exchange rate arrangement provided an appropriate framework in which financial discipline could be exercised. In that regard, although the staff had been critical in the past of the limitations imposed on domestic interest rates in the Bahamas, there was no doubt that Central Bank policies had been and remained cautious with regard to domestic credit expansion.

Existing exchange controls, in conjunction with the fact that the Bahamas was composed of islands, had limited capital outflows in 1981-82, when interest rate differentials between assets denominated in U.S. and Bahamian dollars had been large, the staff representative from the Western Hemisphere Department observed. Nevertheless, there had undoubtedly been some capital outflows, and it was true that they had not been fully reflected in the official statistics. The staff believed that some of the outflows were contained in the net errors and omissions item, as a Director had suggested. However, as noted in SM/83/65, the statistical discrepancy had declined sharply between 1981 and 1982.

Mr. Joyce remarked that he agreed with the staff that there was no basic disagreement between the authorities and the staff on the short-term fiscal position. The authorities intended to pursue tax collection vigorously, and he expected that their efforts would bear fruit. The authorities also intended to restrain expenditure, including wages. They had decided that the amount available for wage increases would not exceed B$10 million in 1983, B$8 million in 1984, and B$7 million in 1985. The distribution of those amounts remained under discussion, and a decision could be expected in the near future.

Commenting on the medium-term outlook, Mr. Joyce noted that the staff viewed the prospects as difficult, and that Mr. Taylor had suggested that contingency measures might need to be in hand in case the hotel project turned out to be less profitable than expected. The authorities would not fundamentally disagree with those views, but they felt that it was a little too early to reach decisions. For example, the hotel complex would not open until the fall of 1983. The authorities intended to reassess the situation in December and to consider whether the assumptions made in the staff's medium-term outlook remained reasonable, and whether additional measures would need to be taken to deal with any emerging problems.

The staff had ably explained the reasons for the authorities' continued pursuit of parity between the Bahamian dollar and the U.S. dollar, Mr. Joyce commented. It was true that interest rates had been allowed at times to slip below the levels of U.S. interest rates for a number of reasons: social policy had played a role, particularly with regard to housing, and the authorities had not always been certain what direction interest rates in the United States might take. It had never been their intention, however, to maintain lower interest rates as a permanent feature of Bahamian policy, and they were holding rates stable at present in order to bring them more into line with falling U.S. interest rates. They did not rule out the possibility that Bahamian rates could be allowed to rise slightly above U.S. rates if that approach appeared desirable.

The Acting Chairman then made the following summing up:

> Directors noted that tourism and overall economic activity had registered modest increases in 1982, in spite of the continued adverse effects of the international recession on the Bahamian economy. In the short term, Directors foresaw a moderate pickup in economic growth, but foresaw that the Government might encounter difficulties in financing the fiscal deficit for 1983 without some crowding-out of private expenditure. In that regard, Directors welcomed the steps already taken to increase government revenues and to raise the prices charged by some public corporations. However, they noted that further efforts would be necessary to hold down the rate of increase in government expenditures,

especially salaries. In view of the recent large increase in the foreign currency debt of the public sector, Directors observed that a further substantial rise in external borrowing by the Government would not be appropriate.

Directors felt that the medium-term prospects for government finances indicated the need for an early and significant tightening of the fiscal position. They supported the Bahamian efforts to absorb foreign investment and to diversify economic activity. Directors observed that the Bahamian authorities' desire to maintain a fixed relationship between the Bahamian dollar and the U.S. dollar implied a considerable degree of financial and monetary discipline. In those circumstances, a number of Directors felt that a more flexible interest rate policy might be appropriate; such a policy could also encourage financial savings and improve the allocation of credit.

Directors also stressed that the competitive position of the Bahamas should not be allowed to deteriorate. They noted that wage-price inflation had moderated substantially over the past two years, but they felt that there was a need for further tightening in the area of wages. Efforts to restrain public sector salaries could help to improve the fiscal position and would also have a favorable influence on wage settlements in other sectors of the economy.

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

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LEO VAN HOUTVEN
Secretary