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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/82

10:00 a.m., June 8, 1983

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	T. Ramtoolah, Temporary
J. de Groote	G. Ercel, Temporary
	P. D. Péroz, Temporary
	J. Delgadillo, Temporary
R. D. Erb	J. C. Williams, Temporary
	T. Alhaimus
	Jaafar A.
	T. Yamashita
R. K. Joyce	M. Casey
	C. Robalino
	G. Grosche
	P. Kohnert, Temporary
G. Lovato	C. P. Caranicas
	A. S. Jayawardena
	S. El-Khouri, Temporary
	J. Schuijer, Temporary
A. R. G. Prowse	K. G. Morrell
G. Salehkhou	O. Kabbaj
F. Sangare	
M. A. Senior	E. Portas, Temporary
	I. Fridriksson, Temporary
	C. Taylor
	J. Bulloch, Temporary
	Wang E.

L. Van Houtven, Secretary
J. C. Corr, Assistant

Also Present:
B. Legarda, Consultant. African Department: O. B. Makalou, Deputy Director; A. Basu, E. L. Bornemann, C. V. Callender, A. B. Diao, Z. Ebrahim-zadeh, J. W. Kratz, D. J. Scheuer, I. C. Tandeciarz. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Kanesa-Thasan. External Relations Department: R. W. Russell. Fiscal Affairs Department: H. Bierman, A. Feltenstein, I. S. McDonald. IMF Institute: I. A. Bello. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; H. Elizalde, J. K. Oh. Treasurer's Department: D. Williams, Deputy Treasurer; W. L. Coats, R. Dunn. Western Hemisphere Department: J. C. Di Tata, J. E. Gonzalez, M. E. Hardy, H. E. Khor, D. C. Ross, M. C. Spinola, J. E. Sundgren, G. Yadav. Advisors to Executive Directors: S. R. Abiad, L. Doe, S. M. Hassan, I. R. Panday. Assistants to Executive Directors: E. M. Ainley, H. Arias, L. Barbone, R. Bernardo, T. A. Connors, M. K. Diallo, C. Flamant, A. Halevi, M. Hull, M. J. Kooymans, P. Leeahtam, J. A. K. Munthali, V. K. S. Nair, Y. Okubo, G. W. K. Pickering, Shao Z., D. I. S. Shaw.

1. GUINEA-BISSAU - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Guinea-Bissau (SM/83/81, 5/13/83; and Cor. 1, 6/6/83). They also had before them a report on recent economic developments in Guinea-Bissau (SM/83/95, 5/23/83).

Mr. Alfidja made the following statement:

> The first Article IV consultation with Guinea-Bissau was held in 1978 against the backdrop of administrative and economic structures that were virtually destroyed by a 13-year long war for independence. Since the coming to power of a new Government, intense discussions have been under way among the authorities regarding the determination of political and economic paths to be followed by the country. As can be expected, the process toward reaching a realistic consensus on the political and economic orientations and on the means to achieve the objectives is time-consuming. The Government of Guinea-Bissau accords great importance to the need to reach a national consensus as it will constitute the basis for the development effort in the years to come. The delay in reaching such a consensus has contributed to the late holding of the last consultation under the Article IV provisions. In this connection, on behalf of my authorities, I would like to thank the staff for preparing the updated papers on the country.
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> The overall economic activity in Guinea-Bissau has fluctuated considerably over the years 1979-82. This is reflected by a fall in real GDP during the early part of the period that reached nearly 15 percent, followed by a sharp recovery in 1981 when total output was estimated to have risen by nearly 24 percent. A slowdown in economic activity occurred in 1982 as real GDP advanced by just close to 6 percent. Since agricultural production accounts for half of the total output of the economy and is very dependent on weather conditions, changes in real GDP are a reflection of variations in the climatic situation. The decline in total output in 1979 and 1980 was due largely to sharp decreases in the output of rice and groundnuts, resulting from the severe drought conditions that prevailed. Likewise, the recovery in the output of these crops in 1981 and 1982 as a result of timely rainfalls, has led to the rebound of total output. The expansion of total economic activity has been enhanced by government measures such as the rehabilitation of irrigation dikes, and the supply of farm implements and vehicles. Agricultural producer prices have also been raised in order to stimulate output. A further improvement in real economic activity is expected in 1983 and 1984. Inflation seems to have subsided, although the authorities are aware that a new survey is needed for price developments to be monitored adequately.

The fiscal performance in Guinea-Bissau should be reviewed in the context of a newly independent country whose administrative machinery and economic base have been severely damaged by a devastating war as mentioned above. Albeit the economic potential of the country is substantial, the development of the resources is in its infancy, which explains the low tax base. On the other hand, pressing demands (staffing of administration, construction of schools, hospitals, roads, purchase of food for drought relief, etc....) on the very limited financial receipts of the Government needed to be met. Principally, as a result of the aforementioned factors, large overall fiscal deficits have been recorded over the years. The significant increase in the deficit from 49 percent of GDP in 1979 to nearly 67 percent a year later was mainly due to a general salary increase granted in 1980, the first since 1975, and to a rise in capital outlays. The overall government deficit declined to about 43 percent of GDP in 1981, reflecting a more buoyant revenue development combined with a substantial decline in capital expenditure. On the basis of preliminary data, the fiscal outturn is estimated to have worsened in 1982, for the deficit has increased to nearly 50 percent of GDP. This outturn resulted chiefly from a fall in corporate profits tax (partly due to a slowdown in economic activity) as well as from a decrease in nontax revenue arising from the closing of a major fishing company and the removal from operations of some fishing vessels for maintenance. The Government of Guinea-Bissau is very concerned about this fiscal situation. Pending the completion of policy discussions under way within the Government, instructions have been given to tighten expenditure controls. On the revenue side, the income tax regulations have been revised and a new tax code has been enacted with a view to increasing government receipts.

As is often the case in economies where the major emphasis is placed on central planning, monetary developments in Guinea-Bissau reflect the fiscal needs of the public sector. My authorities are fully aware of the unfavorable effects of the relatively expansionary fiscal policies undertaken during the last few years on economic activity in general, and on the monetary and external sectors in particular. Therefore, they intend to reduce the Government's recourse to bank credit as the fiscal situation improves. Regarding interest rate policy, the Government is currently considering, inter alia, the possibility of authorizing the payment of interest rates on deposits in order to stimulate savings.

Concerning the external sector, the current account deficit has declined to about 18-19 percent of GDP during 1981-82, down from 30 percent in 1980 and 28 percent in 1979, due mainly to an increase in exports and a decline in imports, the latter movement reflecting the shortage of foreign exchange. As a result of a substantial fall in medium and long-term capital and of large amortization of short-term borrowings, the overall balance of payments deteriorated significantly in 1982 when the deficit reached $22.3 million, compared with $9.1 million in 1981. These developments have led to an accumulation of external arrears and to an external debt situation which is of great concern to the Government. The authorities of Guinea-Bissau are exploring the possibility of undertaking negotiations with the creditors aimed at finding a solution to the problems of existing arrears and of the debt service due in 1983 and 1984.

Following lengthy Cabinet discussions, the Government has put forward for the first time, an Economic Stabilization Program covering the period 1983-84. This program is a prelude to a more comprehensive four-year economic development plan (1983-86). The main objective of the 1983-84 program is to boost agricultural output to achieve self-sufficiency as well as to diversify the export base. Toward this end, the agricultural producer price of crops such as rice, groundnuts, and cashew nuts will be raised to levels close to world market prices. Furthermore, some public enterprises will be restructured with a view to improve the marketing and distribution of agricultural products. In the latter respect, the private sector's role in the marketing of these commodities will be encouraged.

Under the medium-term Development Plan under preparation, the authorities of Guinea-Bissau propose to undertake structural measures aimed at reducing the internal and external financial imbalances of the economy. In the fiscal sector, emphasis will be placed on establishing a modern statistical apparatus. Furthermore, both the recurrent and capital budgets will be prepared and implemented under the supervision of the Ministry of Finance. Budgetary discipline will be strengthened. For 1983 specifically, total nominal spending is to be frozen at its 1982 level. As regards the external sector, although my authorities have doubts about purported favorable effects of devaluation, they are considering the possibility of a readjustment of their currency exchange rate within the context of a coherent macroeconomic policy package. Finally, in the real sector, the Plan proposes the establishment of investment priorities which stress development in the primary sector, the selection of labor-intensive projects, and the efficient use of existing capacity.

My authorities recognize that much remains to be done in order to build an appropriate economic and financial base. They would like to work in close cooperation with friendly countries, and international institutions such as the Fund and the World Bank, in order to achieve their goals.

They expect a staff visit to Bissau soon to pursue discussions for a Fund-supported stabilization program.

Mr. Erb stated that he was in broad agreement with the staff appraisal and that he could support the proposed decision. It was regrettable, although perhaps understandable, that such an extended period of time had been allowed to elapse between the previous and the current Article IV consultation with Guinea-Bissau. He welcomed the most cooperative attitude of the authorities, and he strongly urged them to be vigilant so as to ensure that the next Article IV consultation would be held on the standard 12-month cycle. The macroeconomic policy discussions and insights gleaned during such consultations would be of particular value to the Guinea-Bissau authorities as they pursued the reassessment of their economic strategy. In that context, he strongly supported the emphasis placed by staff on the urgent need to justify the existing inadequacies in the economic data base. Because of those inadequacies, his remarks would be of a general nature.

One of the most pressing challenges facing the authorities, Mr. Erb commented, was the need to adopt and to implement a range of macroeconomic policies that would support their broader development policies and that would effectively contribute to the needed structural adjustment of the economy. The Fund staff could help in that regard by developing with the authorities an explicit forward-looking framework. Such a framework would provide the necessary medium-term perspective so that the critical policy options could be evaluated and appropriate choices could be made.

He was more skeptical than the staff appeared to be, Mr. Erb continued, regarding the eventual efficacy of the economic stabilization program described in SM/83/81 and SM/83/95. There was evidence that the program represented a significant reorientation relative to past policies and that it was on the right track. However, viewed in the context of future challenges and opportunities facing Guinea-Bissau, the economic stabilization program clearly did not go far enough, and it did not face up to the need for immediate action. He fully endorsed the staff conclusion that the major weaknesses were in exchange rate and producer pricing policies, and he strongly encouraged the authorities to move quickly to adopt the staff's recommendations in those critical policy areas.

There appeared to be scope for a significantly increased role--indeed a lead role--for the World Bank group in Guinea-Bissau, Mr. Erb suggested, particularly in the area of structural adjustment. Had consideration been given to establishing a consultative group for Guinea-Bissau under the aegis of the World Bank? His chair continued to believe that the Fund could play a vital role in consultative groups even when the member did not have a financial arrangement with the Fund. The present situation in Guinea-Bissau presented a unique opportunity for the international community and the authorities, not least because of the considerable economic potential that the country possessed.

The Acting Chairman made the following summing up:

The Executive Directors, taking note of the statement made by Mr. Alfidja, broadly agreed with the thrust of the staff appraisal in the report for the 1983 Article IV consultation with Guinea-Bissau.

It is expected that the next Article IV consultation with Guinea-Bissau will take place on the standard 12-month cycle.

The Executive Board then took the following decision:

Decision Concluding 1983 Article XIV Consultation

1. The Fund takes this decision relating to Guinea-Bissau's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1983 Article XIV consultation with Guinea-Bissau, in the light of the Article IV consultation with Guinea-Bissau conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Guinea-Bissau continues to maintain restrictions on payments and transfers for current international transactions, including external payments arrears and a bilateral payments agreement with a Fund member, as described in SM/83/95. Guinea-Bissau's external payments arrears have increased since the last Article IV consultation. The Fund encourages Guinea-Bissau to eliminate arrears for current international transactions as soon as possible. The Fund also encourages Guinea-Bissau to reduce its reliance on other exchange restrictions and, in particular, to terminate the bilateral payments arrangement with a Fund member as soon as possible.

Decision No. 7418-(83/82), adopted
June 8, 1983

2. ST. LUCIA - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with St. Lucia (SM/83/78, 5/13/83). They also had before them a report on recent economic developments in St. Lucia (SM/83/79, 5/17/83; and Cor. 1, 6/6/83).

The staff representative from the Fiscal Affairs Department made the following statement:

Since the consultation, the budget for fiscal year 1983/84 has been passed. On current account, the budget is in line with the staff report projections for 1983/84, while budgeted capital expenditure exceeds the projections. However, execution of the capital program is subject to availability of higher than projected project loans.

Negotiations are still ongoing with the Civil Service and the daily paid workers. Our most recent information is that the Government had so far maintained its position that no salary increase will be granted this year.

The Government's liquidity position is still tight, and it is exercising the utmost expenditure restraint.

Mr. Casey made the following statement:

Recent Developments

In 1982 the real GDP of St. Lucia rose by slightly more than 2 percent despite the large fall in private investment following the completion of the Hess Oil transshipment terminal. On the expenditure side, the contributions to growth in 1982 came mainly from consumption--reflecting high wage awards--and from an improvement in the real external balance. On the output side, the manufacturing sector expanded strongly after stagnating in 1981. There was also good growth in agriculture, especially coconut production; this was in large part a lagged recovery from the hurricane damage inflicted in 1979 and 1980. Economic growth is expected to remain modest in 1983, constrained in large part by the availability of foreign financing (including grants) and the need to reduce budgetary arrears. It is unlikely that the unemployment rate of some 27 percent will be significantly reduced in the near future.

The rate of increase in consumer prices had fallen markedly from 15 percent in 1981 to 4.6 percent in 1982 and is expected to fall further to about 4 percent this year. This improvement in the inflation rate largely mirrors international price developments. It is interesting to note that almost all interest rates are now positive in real terms; indeed the prime lending rate (13 percent nominal) is probably excessive in relation to domestic investment needs.

The current external deficit, excluding Hess transactions, rose to almost 13 percent of GDP in 1982. This deficit was financed by official capital inflows, including a special sale of Treasury Bills to neighboring Governments. There may also have been some private inflows included in the large errors and omissions items; these flows could, conceivably, have been induced by higher interest rates but it is hard to tell. The current external deficit is expected to improve markedly in 1983; this is mainly because the capital inflows will not be adequate to finance a larger current deficit. As a member of the East Caribbean Currency Authority (ECCA) St. Lucia's current external position is largely determined by external capital movements. With direct investment by the Hess Company greatly reduced in 1983 and with lower external borrowing by the public sector, the current balance of payments deficit has to contract because there is no way of financing a larger deficit.

One of the unfortunate side effects of this automatic tendency toward equilibrium is that imports of essential capital goods will not be adequate for the developmental needs of the country in terms of infrastructure and diversification toward light manufacturing.

Policies

In light of the constraints of ECCA membership, the main thrust of policy has to focus on two main areas which are interlinked, viz, the public finances and wages.

Current expenditure of Central Government has grown rapidly in recent years resulting in a current fiscal deficit equivalent to more than 2 1/2 percent of GDP in FY 1982/83 and a build up of arrears. This deterioration occurred despite laying off 2,000 daily-paid workers in 1981, and increasing the ratio of revenue to GDP. Clearly increases in wage rates were too high. But, more generally, severe diseconomies of scale in small island economies, such as St. Lucia, make it very difficult to achieve equilibrium in the public accounts.

For FY 1983/84 the authorities are determined to maintain the total wage bill at its level in FY 1982/83, excluding retroactive payments made in that year. This will be accomplished by a freeze on wage rates, or, if need be, by further redundancies. A constant wage bill and tighter expenditure control generally is likely to generate a surplus in the current account of Central Government in FY 1983/84 which will help to defray arrears.

Some increase in public investment is expected, consistent with World Bank recommendations, but this depends to a large extent on the availability of adequate capital grants. The net result in FY 1983/84 is likely to be a small overall deficit on Central Government operations. The rest of the public sector, which has been made more efficient, is not likely to affect this position materially. It is hoped that the retrenchment of the consolidated public sector will, inter alia, reduce the upward pressure on interest rates and elicit a positive response from the private sector. The latter is crucial, especially in a medium-term context.

The authorities are also aware of the need for realistic wage guidelines in the private sector. This is especially important given the real appreciation of the exchange rate and, in particular, the recent movements in the currencies of the United Kingdom and Mexico and the changes in the exchange system of Jamaica.

Finally, the authorities of St. Lucia are grateful to the staff for conducting this Article IV consultation in a constructive manner and for producing reports of such high quality. They are in general agreement with the staff appraisal.

Miss Bulloch commented that it was encouraging that the economy of St. Lucia continued to make a fairly steady recovery from the 1980 hurricane and the subsequent period of overexpansionary domestic policies. Real GDP growth remained positive, inflation had abated, and, in 1983, the current account deficit was projected to be halved to about 6.5 percent of GDP, excluding the Hess Oil terminal element. However, the projected external deficit would remain too high to be sustainable, so that, while the authorities had made a good start, further corrective measures would be necessary. She agreed with the staff appraisal on the focus that the adjustment effort should have.

To the extent that St. Lucia was constrained in external adjustment by membership in the East Caribbean Currency Authority (ECCA), Miss Bulloch continued, the burden of adjustment would fall on domestic policy, particularly fiscal policy. It was worth noting that the appreciation of the East Caribbean dollar, in line with that of the U.S. dollar, had caused problems for St. Lucia. Neighboring economies had suffered in a similar way, raising the question whether a devaluation of the East Caribbean dollar might be justified. It was an option that the authorities might consider reviewing with the other members of the ECCA. Could the staff comment on whether the agreement that had been reached to convert the ECCA into a full-fledged central bank would facilitate the holding of joint consultations between the Fund and the members of the ECCA?

Commenting on fiscal policy, Miss Bulloch considered that the authorities should be commended for the actions already taken to contain current expenditure. However, the experience of fiscal year 1982/83, when a projected surplus had turned into a deficit of more than 2.5 percent of GDP, showed that fiscal action remained an urgent priority. Her authorities agreed that the impact of wage policy upon the economy was the crucial issue in that regard. Recent wage settlements had clearly been excessive in the light of lower inflation. The authorities recognized that further increases would have to be curbed in order to reduce the budget deficit, and they deserved the Executive Board's full support for the firm line that they had taken on wages. The authorities' apparent readiness to offset wage increases by reductions in the government work force was somewhat surprising. With unemployment at about 27 percent, firm wage control was preferable to further redundancies.

The current account of the Central Government was again projected to record a surplus in 1983, Miss Bulloch noted. While that projection was based largely upon expenditure control, it also included a planned increase in revenue. Could the staff comment on how much of the increase was expected to arise from the oil throughput tax following the completion of the Hess transshipment terminal? Once the projected surplus had been achieved, it would be important to use it in the right way. She agreed that the surplus should enable payments arrears to be reduced. The repayment of the commercial bank overdraft would also be an important priority so as to release funds for private investment. The squeeze on private sector credit caused by excessive government borrowing was a worrying development that should be reversed.

The financing of the public sector investment program would depend upon the receipt of capital grants, Miss Bulloch remarked. The involvement of the World Bank in the drawing up of investment priorities was welcome. It was intended to develop four major projects simultaneously. Although project assessment was not usually a concern of the Fund, she asked the staff whether the simultaneous effort was overambitious, given the expenditure implications and the fragility of the Central Government accounts.

The agreement between the staff and the authorities on the need to place fiscal adjustment in the medium-term context was welcome, Miss Bulloch went on. Clearly, it would take time to consolidate the benefits of the moderate fiscal stance adopted. In that regard, Fund financing, possibly a one-year stand-by arrangement, might be appropriate in support of the adjustment effort being undertaken. She recalled that the authorities had expressed an intention to enter into a Fund-supported program at the time of their emergency drawing in 1980. Had the St. Lucian authorities given recent consideration to that possibility?

Finally, the current edition of International Financial Statistics (IFS) recorded data on St. Lucia for the first time, Miss Bulloch noted, which was welcome evidence of progress made in developing comprehensive statistics on the economy. The data would also help to test hypotheses emerging from the study of small, developing island countries to be considered by the Executive Board later in 1983.

Mr. Delgadillo said that he agreed broadly with the staff appraisal. In the previous two years, after having been significantly affected by natural disasters, the economy of St. Lucia had been recovering at a moderate positive rate of growth, although the 27 percent unemployment rate appeared excessively high. The current account deficit of the balance of payments for 1983 was expected to reach 6.5 percent of GDP, basically due to a small improvement in export performance and a reduction in the nominal value of imports.

The conditions prevailing in international markets had contributed extensively to the moderation of inflationary pressures from 15 percent to 4.6 percent in one year, and to the maintenance of high positive interest rates, Mr. Delgadillo continued. In the face of a continued loss of competitiveness arising from the appreciation of the exchange rate, and in light of the constraints derived from St. Lucia's membership in the ECCA, the emphasis of policy had to be placed on public finances and wages. The implementation of a medium-term policy directed at a reduction in the fiscal imbalance was crucial. Only adequate wage policies and expenditure controls would permit coherent interest and investment policies to sustain private sector economic growth and the achievement of reasonable targets in the external sector. He hoped that the authorities' commitment to pursue such policies would be carried out without hesitation. He invited the staff or Mr. Casey to comment on the pros and cons of St. Lucia's membership in its present currency arrangement and on the vulnerability of the economy with regard to the exchange rate actions of other countries.

Mr. Morrell remarked that, like most small island economies, St. Lucia was extremely vulnerable to external influences, both economic and meteorological. The global recession and hurricane Allen had contributed profoundly to the reduction in real per capita growth from 8 percent in 1979 to a decline in 1980 and to the current slow growth. Structural factors, common to many small island economies, such as limited markets and a small resource base, had constrained agriculture and manufacturing activity to 23 percent of GDP, severely limiting long-term growth prospects of the economy.

Those factors had been compounded by inappropriately large public administration costs and overgenerous wage awards during 1980-82, Mr. Morrell continued, as recognized by the authorities and the staff. They had critically enlarged the deficits, leading to an accumulation of fiscal arrears and to consequent crowding out of credit and other resources to the private sector. The authorities' current efforts to address those problems by strengthening public finances and by containing wage increases were, therefore, welcome.

St. Lucia's membership in the ECCA had enforced discipline on the external sector, Mr. Morrell noted. However, while external imbalances were thereby avoided, the consequent cost was low growth. He invited the staff to comment on whether membership in the ECCA had been a net benefit to St. Lucia in those circumstances. Public sector investments, in geothermal energy sources and in the industrial free zone, which could possibly make enormous contributions to growth for a small economy, implied large external financial requirements. What was the source of the constraints mentioned in SM/83/78 on St. Lucia's ability to borrow for those projects? Was it the size of the country, membership in the ECCA, or another problem?

He was interested in the staff's recommendation that an increase in import duties on consumer goods was preferable to the authorities' proposed selective credit schemes as a means of directing available credit toward productive sectors, Mr. Morrell remarked. Tariffs and import quotas created distortions and they had an impact on prices; furthermore, it was not clear that they could stimulate production in specific areas for a small economy, particularly since the productive areas were probably not in the import-substituting but in the export-oriented industries. Selective credit could have greater potential for directly encouraging investment and production in specifically identified areas. The staff suggestions appeared to amount to a fiscal proxy for a devaluation and, in that regard, he wondered whether the staff considered that an overvalued exchange rate was a problem for the authorities, given their inability to change the rate because of St. Lucia's membership in the ECCA.

The staff representative from the Fiscal Affairs Department said that the staffs of the Fund and of the ECCA had undertaken a preliminary study that indicated that the differences in the effective exchange rates of ECCA member countries were mainly related to the direction of each country's trade with different trading partners. Those countries that traded mainly with the United States or with countries whose currencies had been linked to the U.S. dollar had experienced higher effective appreciation since 1980 than the countries whose trade had a lower U.S. weight. In St. Lucia's case, however, the staff had noted in SM/83/78 that there had been a depreciation between 1976 and 1980 that almost offset the appreciation that had occurred since 1980. The staff believed that, in view of the differences in exchange rate developments among ECCA countries, it would be appropriate to discuss exchange rate issues through a joint consultation with ECCA members. Such a consultation would not be a formal Article IV consultation, and it should be limited to specific issues of common concern to ECCA members, in particular, the exchange system. In that regard, the discussions might cover not only the appropriateness of the value of the ECCA dollar, but also its link to the U.S. dollar. A joint consultation had not yet been arranged, but the staff would endeavor to arrange one in 1983, particularly since the ECCA would become a full-fledged central bank before the end of the year.

Commenting on the simultaneous execution of the four major projects in the public sector investment program, the staff representative emphasized that all four projects had a high priority. Two were currently at a preliminary stage, and, although the authorities had requested financing from potential aid donors for all four projects, it was envisaged that there would be lags between the identification of financing and the execution of a project. In that sense, they would not, in practice, be carried out simultaneously. One project in particular, the geothermal project, was essentially a turnkey project, so that once the necessary machinery was brought in there would be few implementation problems. The other three projects would be appropriately phased.

It had originally been expected that, after completion of the transshipment terminal, the throughput tax of 2 U.S. cents per gallon to be paid by the Hess Oil Company would yield about EC$6 million a year, the staff representative remarked. In 1982, the estimate had been EC$3.5 million, because the terminal had not been finished until midyear. However, trading patterns in the Caribbean had changed, with the result that the Hess Oil transshipment terminal was scarcely used. In 1982, the budget had received only EC$0.7 million, and the estimate for 1983 was about EC$1 million. In addition, the completion of the terminal had involved a reduction in the number of highly paid construction workers, a group that had imported a good deal. As a result, the Government would suffer a decline in revenues from import duties. However, the most important effect of the terminal on government revenues stemmed from the fact that probably because the Hess Oil Company was exempt from paying taxes--other than throughput taxes--it had given the Government of St. Lucia capital grants for school construction and maintenance. Those grants had amounted to approximately EC$5 million a year in the previous two years and were estimated at approximately EC$5.5 million in the current budget.

The major factor affecting St. Lucia's borrowing capacity was its size, the staff representative from the Fiscal Affairs Department commented. Because it was a small country and not well known, potential creditors were reluctant to lend. The staff had discussed with the St. Lucian authorities the possibility of a financial arrangement with the Fund. The authorities had inquired whether the financial program discussed in SM/83/78 would be considered an adequate basis for Fund support. The staff had responded positively, but it had received no further approach from the authorities. It appeared that the authorities wished to settle the issue of salaries before proceeding further, a course of action that the staff considered prudent and appropriate.

The Deputy Director from the Exchange and Trade Relations Department noted that some Directors had raised the question of the costs and benefits of membership in a currency union. In St. Lucia's case, practical considerations played a major role. A country of its size would find it most difficult, in practice, to have an independent exchange rate policy, central bank, exchange controls, and the like. The availability of qualified personnel was in itself an important factor.

Mr. Casey remarked that the authorities continued to hope that they could achieve a freeze on wages in 1983/84. They much preferred the option of a freeze to the alternative of creating further redundancies; they would also seek to prevent the resurgence of wage claims after the expiration of the freeze. They had proposed to set up a tripartite forum in which the Government, employers, and employees could discuss wage policies, industrial relations, and related matters.

The authorities had certainly not ruled out the possibility of entering into a financial arrangement with the Fund, Mr. Casey continued. At present, they were considering a number of financial options, including a commercial bank loan, assistance from the Caribbean Development Bank, and financing from potential aid donors. However, they did not believe it would be appropriate to consider actively an arrangement with the Fund until the wages question was settled.

Import duties had been increased in the recent past, Mr. Casey noted. At present, however, the authorities preferred to use selective credit controls on a small list of commodities as a means of signaling to the community the need to restrain imports of luxury goods. The selective credit policy was not very formalized and it was designed mainly to help to create a climate favoring investment over consumption. The policy would be reviewed in a year's time.

The possibility of joint consultations with ECCA member countries to discuss the exchange system seemed reasonable in principle, given the consent of the members concerned, Mr. Casey observed, but it might present logistical difficulties and it could place a strain on staff resources because the normal Article IV consultation would also be held. In addition, the particular circumstances of each country would have to be taken into account. For example, the effective exchange rate for different ECCA members varied significantly. In general, it could be argued that the effective rate for St. Lucia was somewhat overvalued at present in light of recent currency changes in the United States, the United Kingdom, and elsewhere. However, it might not be worthwhile changing long-standing exchange rate relationships for reasons that could prove to be temporary. St. Lucia could improve its competitiveness by firm control of wages and restraint in fiscal policy.

With regard to the balance of payments, Mr. Casey added, it could be argued that under a fixed exchange system there was an automatic tendency for the balance of payments to be self-sustaining. However, the necessary adjustment occurred at the cost of domestic economic activity, as was happening in St. Lucia at the moment. Finally, the World Bank had endorsed the overall investment strategy, including the four major investment projects, and the authorities did not anticipate major implementation problems or significant recurring fiscal costs as the projects developed.

The Acting Chairman commented that the sustainability of a balance of payments position depended not only on the appropriateness of the exchange rate but also on developments in the domestic economy. With regard to joint consultations with ECCA members, he noted that the staff representative from the Fiscal Affairs Department had been careful to state that such consultations would not be Article IV consultations and that they would be limited to matters of common interest among the ECCA countries, such as the exchange system, the level of exchange rates, and exchange controls. Because the effective exchange rate for different members of the ECCA varied, owing to differing trade patterns, it might be worth exploring the possibility of pegging the East Caribbean dollar to a currency basket rather than to the U.S. dollar.

The Deputy Director of the Exchange and Trade Relations Department agreed that the concept of sustainability of the balance of payments had to take into account the prospects for the growth of the domestic economy. Sustainability also had to be considered in light of the individual circumstances of different countries. On the question of joint consultations, he agreed that they could not take the place of Article IV consultations. The topics for consideration would have to be carefully chosen and limited to matters of joint interest, as the Acting Chairman had indicated.

The Acting Chairman then made the following summing up:

> Directors noted that St. Lucia's economy had recovered moderately in 1981 and 1982 while inflationary pressures had abated. However, those improvements had been accompanied by a deterioration in fiscal performance as well as in St. Lucia's underlying deficit on the current account of the balance of payments in 1982; the high rate of unemployment was also a source of great concern. Taking into account the policy constraints on the authorities that stemmed from St. Lucia's membership in the East Caribbean Currency Authority (ECCA), the burden of adjustment fell on domestic measures, in particular wages and fiscal policy.
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> Directors concurred with the staff's assessment that excessive wage increases had caused the deterioration in the performance of the Central Government, notwithstanding revenue buoyancy.

The present firm policy on civil service wages was endorsed. Directors agreed that the necessary corrective action should focus on expenditure policy, in particular on containment of the wage bill, so as to sustain a current fiscal surplus. Directors expressed concern that the Central Government had been crowding out the private sector, absorbing resources directly through its accumulation of payment arrears, and indirectly through its use of banking system resources. Directors noted that the St. Lucian authorities were committed to reducing the burden of public administration, thus gradually returning government finances to a sustainable position.

Questions were raised regarding the appropriateness of the exchange rate for St. Lucia's economy, a matter that would need to be examined jointly by ECCA members in informal discussions, the possible nature of which was currently being considered by the staff. Directors noted that the authorities had raised with the staff the question of whether the intended fiscal program could be the basis for a program with the Fund, that the staff response had been positive, and that the St. Lucian authorities were still considering the matter. It was observed that it would be desirable for St. Lucia to have a financial program supported by the Fund.

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

3. ETHIOPIA - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Ethiopia (SM/83/77, 5/12/83). They also had before them a report on recent economic developments in Ethiopia (SM/83/92, 5/23/83).

The staff representative from the African Department stated that the following information had been conveyed to the Fund staff by the staff of the World Bank:

Agreement has been reached with Fuji Spinning Company of Japan on a compensation settlement for its share in the Cotton Company of Ethiopia. Agreement has also been reached with IFC for compensation of its share in the same company. The Fuji settlement amounts to about $2.81 million, and the IFC settlement to about $1.42 million.

Mr. Sangare made the following statement:

I should like to thank the staff for their papers which provide a clear picture of recent developments in the economy of Ethiopia since the last Article IV consultation concluded by this Board's discussion exactly a year ago. At that time, Executive Directors also reviewed the performance under the 18-month stand-by arrangement which was in support of a stabilization program adopted by the authorities in the last half of the fiscal year 1980/81. It is pleasing to note that the program was successfully implemented with all the quantitative performance criteria met, and drawings on Fund resources made according to the schedule.

Reflecting the successful implementation of the program, significant achievements were made in 1981/82 on the fiscal front and in the external sector. The current budgetary surplus rose from 0.1 percent of GDP in 1979/80 to 1.4 percent in 1981/82 while the overall deficit, at 4.9 percent of GDP in 1981/82, was well below the target of 5.6 percent. The overall balance of payments moved from a deficit of SDR 47.5 million in 1980/81 to a surplus of SDR 53.2 million in 1981/82. Ethiopia was accordingly able to build its external reserves to the equivalent of 5.8 months of imports in 1981/82.

Growth of real output at an annual average of 2.9 percent over the past two years, though lower than expected, was still significant against the general background of a slowdown in the world economy. It is to be noted that the rise in output was higher than the rate of population growth, estimated at 2.3 percent. In the meantime inflation remains low. The overall performance of the economy during the last two years indicates the potential for higher rates of growth in the future, and as the staff report indicates, the growth rate of GDP is expected to rise to 4.8 per cent in 1982/83.

The 1983/84-1985/86 investment program which was drafted in March of this year sets out the medium-term perspective within the framework of the Ten-Year Plan and is aimed at accelerating the growth rate to 6.0 percent in the first year and to 6.5 percent in the final year. In order to achieve these growth targets, total investment amounting to Br 6.3 billion has been planned with a large proportion earmarked for directly productive projects, particularly in the agricultural and industrial sectors. My authorities recognize the important role that foreign assistance will play in the implementation of the development program. Accordingly, the phasing of the planned investment is based on the time profile of foreign aid disbursements as well as domestic resource mobilization.

The strategy for agricultural development emphasizes the improvement of productivity and harvesting techniques, including the construction of better storage facilities. This will be supported by appropriate pricing and marketing policies which will take into account cost developments and other relevant factors. The policy of encouraging smallholders to form producers' and service cooperatives will also continue, the rationale being that this will help to improve extension and credit services as well as develop rural infrastructure. At the same time the irrigation system will be expanded to reduce dependence on rainfed agriculture, while efforts will be made to increase the acreage under state farms. In this regard, the Awash Valley project is to be increased by 2,500 acres a year during the next three years. Although agricultural production is aimed at increasing supply for domestic consumption, the program also stresses the production of export crops such as coffee, tea, cotton, pulses, sugarcane, spices, vegetables, and fruits.

In the industrial sector the authorities intend to raise production for both import-substituting as well as export-oriented industries. With regard to import-substituting industries, efforts will be directed at raising production of basic consumer and intermediate goods including building materials. For the export industries, priority is being accorded to the improvement in the processing of hides and skins, the manufacturing of shoes and other leather products, production of soluble coffee as well as the promotion of handicrafts, among others. In order to attract foreign capital and technology, a proclamation has been issued that should provide the framework for possible joint ventures. My authorities have emphasized that they will protect foreign ownership including the right to sell or transfer such ownership. Some industrial incentives have also been drawn up in support of this program. Meanwhile, agreements have been concluded with owners of all the major nationalized industries with the exception of only two companies. Even for the two outstanding claims, discussions are at an advanced stage.

In 1982/83 fiscal expansion was to provide some impetus for growth. Accordingly, the authorities increased expenditure on the capital account. This was partly to increase equity capital in some of the public enterprises. The authorities are hopeful that this should help strengthen the financial structure of these corporations and increase their ability to continue contributing to government revenue. In the medium term, the tax base should expand, given the fact that investment is directed at productive projects. For the immediate future, however, the authorities are taking steps to strengthen the budget in the 1983/84 fiscal year. In this connection, corporate income tax will be payable on a quarterly basis in order to improve the Government's cash flow position. Other proposals aimed at increasing government revenue include the modification and simplification of the indirect tax system and the changing of specific rates to ad valorem.

Monetary policy has focused on the sale of bonds by the Government to the National Bank and the Commercial Bank to meet capital investments. The authorities have also sought to improve domestic resource mobilization through the expansion of banking facilities in the rural areas. Furthermore, they intend to establish a new debt instrument to further attract private nonbank financial savings, and will be seeking Fund assistance in this regard.

The balance of payments will remain under pressure in the medium term. However, the situation should be helped by increased production of export-oriented goods which is a major priority of the medium-term investment program. In support of the efforts to expand export production, the authorities intend to mount a strong campaign to secure markets both within the region as well as in other parts of the world. In this connection, they are participating in the newly formed Eastern and Southern Africa Preferential Trade Area, which provides potential for increased trade. It is the objective of the authorities to maintain gross external reserves at a minimum level equivalent to three months of imports.

Ethiopia's debt service ratio remains relatively low and provides ample scope for attracting further foreign capital. However, it is the intention of the Government to continue to seek foreign capital on concessionary terms.

It is the view of my Ethiopian authorities that the present exchange rate and trade system is functioning in a satisfactory manner. They do not believe that an exchange rate adjustment at this time would bring about an improvement in the balance of payments. It is felt that import demand is mostly tied to capital investment needs and tends to be inelastic.

Mr. Lovato said that he agreed broadly with the recommendations in the staff appraisal. Relative to fiscal year 1981/82, the performance of the Ethiopian economy in 1982/83 had deteriorated in a number of respects. Among the reasons for the deterioration, the serious weather situation should be emphasized, since the two consecutive years of drought were regarded by many observers as the worst in a decade, endangering the lives of a great number of people. In such circumstances, short-term stabilization clearly became a difficult task. The situation helped to explain why inflation had been much worse than in the previous year, and why the Government had difficulty with increasing food prices further. He invited the staff to provide a more detailed assessment of the effects of the drought on agricultural production and imports.

Under those conditions, Mr. Lovato continued, it became even more difficult for the Ethiopian authorities to pursue their development effort. In that regard, the public sector investment program for the period 1983/84-1985/86 appeared very ambitious; he agreed with the staff that the authorities should be urged to secure financing for the program before attempting its full implementation. The performance of domestic savings, although slightly improved, remained weak, and it needed to be strengthened if total dependence on foreign aid was to be gradually overcome. He welcomed the efforts of the authorities to enlarge the financial network by opening bank branches in rural areas. The interest rate structure appeared broadly appropriate; the staff acknowledged that deposit rates were only marginally negative in real terms. However, it would be advisable to attempt to diversify the term structure of interest rates.

Given the need for resource mobilization, Mr. Lovato commented, the insufficient growth of revenues and the appearance of a deficit in the current account of the budget were causes for concern. They should be addressed by the authorities in order to prevent further deterioration. He welcomed the information that settlements had been reached with almost all the enterprises that had been nationalized. He hoped that support from the World Bank and from other development institutions would, therefore, be forthcoming.

Commenting on exchange rate policy, Mr. Lovato noted that there continued to be disagreement between the staff and the authorities. He could appreciate the authorities' arguments against a devaluation of the birr, as well as the fact that imports were strictly regulated and planned. However, particularly since a great many exports were nontraditional commodities, he believed that the authorities should at least explore the possibility of abandoning the peg to the U.S. dollar, and of adopting instead a currency basket that would help to avoid the fluctuations of nominal and real effective exchange rates indicated in Chart 1 in SM/83/77.

Mr. Ramtoolah observed that overall economic activity in Ethiopia in 1981/82 had been characterized by a fall in real output due to a slowdown in the growth of agricultural production, largely as a result of adverse weather conditions, and a slower expansion of industrial output, reflecting capacity constraints and marketing difficulties. In 1982/83, however, agricultural output was expected to improve markedly due to higher yields and the expansion of irrigated areas. The industrial sector was also expected to pick up, particularly the construction sector, which was anticipated to grow strongly.

In 1981/82 prices had increased appreciably more than in 1980/81, Mr. Ramtoolah continued, reflecting weather conditions, the removal of subsidies, and marketing and distributional inadequacies. The increase in prices was expected to persist in 1982/83 because of continuing adverse weather conditions in certain areas. In the fiscal field, in spite of the increase in revenues from various taxes, the overall budget deficit had increased in FY 1981/82 and it was expected to do so again in 1982/83. The authorities should be prudent in that regard, since the deficit would be financed mainly from domestic sources, unlike the situation in 1981/82.

Commenting on external policies, Mr. Ramtoolah noted that, following four successive years of deficits, a surplus had emerged in 1981/82 in the overall balance of payments. However, the external current account deficit had reached 7 percent of GDP because of lower export prices, a lower volume of exports, and an increase in the volume of imports. The current account deficit was, nevertheless, expected to decline marginally in 1982/83. External debt remained at manageable levels, although vigilance might be called for, given the increasing debt service ratio.

The authorities had proposed a ten-year plan covering the period 1983/84 to 1992/93, Mr. Ramtoolah went on. In that context, a draft public sector investment program for the three-year period 1983/84-1985/86 had been put forward. It envisaged, in perhaps too optimistic a manner, a substantial structural transformation of the economy. The ratio of investment to GDP was anticipated to grow considerably, and the plan contemplated increasing rates of growth of total output in the years to come. The authorities planned to enlist a broad range of financial support, including the private sector and the World Bank, the latter already supporting a major project in the agricultural sector. He hoped that the authorities' expectations of the sources of financing for the plan would be fulfilled. He commended the authorities for the progress accomplished to date, and he wished them further success in their efforts.

Mr. Taylor remarked that, despite a low stage of industrialization and meager external financial support in recent years, Ethiopia had managed to achieve a fair degree of economic stability in most years through prudent management. The sharp deterioration in the fiscal deficit in the current fiscal year emphasized the need to return to stricter expenditure control and other policies to improve public sector finances. In addition to the measures recommended by the staff, the authorities should seek to widen the tax base and to encourage private sector savings. He agreed with the staff that there could be greater flexibility in interest rate policy. Financing the expanded fiscal deficit by major recourse to the domestic banking system had added to inflationary pressures. Both indicators of inflation were expected to rise in 1982/83 despite the appreciating effective exchange rate. It was also a matter for concern that Ethiopia had allowed relative agricultural producer prices to decline in recent years, particularly through a period of serious drought. That undesirable development had affected both export crops and food crops; he strongly supported the staff's appraisal in that regard.

Ethiopia had clearly not recovered from the 40 percent appreciation of the real effective exchange rate that had occurred during a five to six-year period, Mr. Taylor continued. He agreed with Mr. Lovato that the peg to the U.S. dollar had not been the best policy for Ethiopia, and he invited the staff or Mr. Sangare to indicate whether the authorities had considered pegging the birr to a currency basket. They might also wish to consider regaining competitiveness through an adjustment of the rate, despite the fact that Mr. Sangare had stated that they believed that there was no pressing need to move in that direction. As a consequence of the inappropriate exchange rate, the authorities found themselves obliged to continue major restrictions on their current account payments. Those restrictions had been in place for several years, and, in view of the relatively comfortable level of reserves, the authorities should begin to consider relaxing them. He believed that if Ethiopia was to consider further use of Fund resources, phasing out of the restrictions would have to be given attention.

The medium-term prospects for external debt and capital inflows were somewhat overoptimistic, Mr. Taylor considered. He agreed with the staff that achievement of the necessary external financing was questionable. In the circumstances, the authorities should consider all possible sources of external finance, including private capital flows. He hoped that Mr. Sangare would be able to impress on his authorities the need to conclude the negotiations on the remaining compensation claims. If all claims were finally disposed of it would provide a definite signal to other countries that a better climate for external finance existed in Ethiopia. Finally, the authorities should be congratulated for having carried out the recent stand-by program well and for having met all the performance criteria despite major political instability and severe drought.

Mr. Williams welcomed the rational approach that the authorities had adopted to place their development objectives in a longer-term perspective. He agreed with other Directors that the assumptions and targets of the three-year investment program were ambitious, particularly with regard to financing from both domestic and foreign sources. Larger amounts of domestic resources would have to be raised if the medium-term investment goals were to be achieved. He strongly supported the staff recommendation that the authorities should pursue a more vigorous policy to stimulate external financial flows, and he agreed with Mr. Taylor that in support of that objective the authorities should conclude negotiations to settle outstanding compensation claims.

The authorities' decision to re-examine their producer pricing and marketing policies following the recent slowdown in agricultural production was welcome, Mr. Williams continued. He agreed with the staff that price adjustments in the past had not adequately reflected increased production costs and that, as a result, the terms of trade for the productive sector had deteriorated. Exchange rate adjustments would be a necessary complement to domestic price adjustments.

There was a need to regain firm control over budget expenditures, Mr. Williams considered. Too rapid a buildup in domestic liquidity could have an adverse impact on the balance of payments and on domestic prices. He welcomed the authorities' intention to adopt a cautious policy regarding domestic financing of the deficit, and he hoped that that policy would be adhered to. There was also considerable scope for improvement on the revenue side. Some measures to raise revenues had been proposed, but not yet implemented, and he encouraged the authorities to enact those measures at an early date. His authorities particularly welcomed the proposals to reform the indirect tax system, expected to be implemented in the near future. The delay the past two years in granting necessary price adjustments to public enterprises had been another major contributing factor to the loss of budget revenue. He emphasized the importance of adjusting the relevant prices promptly.

Although loan rates were positive, Mr. Williams noted, deposit rates were at present slightly negative. To the extent that the Ethiopian authorities intended to rely on the domestic banking system to finance the deficits and at the same time to limit the size of central bank financing, it would be necessary to mobilize greater savings through bank deposits. Interest rate policy could contribute to such resource mobilization. Finally, the authorities should make every effort to relax restrictions on current international payments and transfers.

Mr. Kohnert commented that it was surprising that Ethiopia had successfully followed a restrictive fiscal policy for some time, given that the per capita income of the country was among the lowest in the world. In addition, it had been able to fulfill all the performance criteria of the recent Fund program, for which the authorities should be commended. Following the mixed results in 1982/83, the authorities were planning to enter into an investment program that could jeopardize the prudent stance of previous years. The plan projected an almost 100 percent increase in investment expenditure over a three-year period in order to improve the low investment/GDP ratio.

However, the authorities did not appear to be paying sufficient attention to the relevance of the country's price structure, including the exchange rate, Mr. Kohnert considered, and to the external constraints that the economy might face, even though they had established a foreign reserve target equivalent to three months of imports. They appeared to attach more importance to technical questions in their development planning. He urged the authorities to bear in mind the financial aspects of their program. He endorsed the staff's appraisal, particularly its comments on producer prices, interest rates, and exchange rate policy.

Expressing doubt about the consistency of the economic projections, Mr. Kohnert added that on page 17 of SM/83/77 the staff stated that imports were allowed to grow only at an annual rate of about 2 percent in real terms, to achieve the objective of maintaining reserves at a level of three months' imports. It was questionable whether that projection was consistent with the expected 6 percent real growth in GDP and the increase in investment expenditures of about 100 percent in nominal terms over a three-year period. Did the staff believe that the investment targets were achievable or that the 6 percent growth rate of GDP was realistic in light of the expected low overall growth of imports? In addition, would import restrictions further reduce the rate of growth of imports because the authorities did not favor devaluing their overvalued currency? Would the projections have to be revised as a result of the prevailing drought in Ethiopia?

The staff representative from the African Department noted that there had been considerable drought in certain regions of Ethiopia in 1981 and 1982, although others had had adequate rainfall. The impact of the drought on the production of major crops was shown in Appendix Table VII of SM/83/92. Some major foodstuffs, such as cereals, grown in drought-affected areas, had suffered a decline, while other foodstuffs, such as pulses, had increased in quantity. The production declines also reflected marketing problems and inadequate producer price incentives. While the staff believed that all three factors had contributed to the decline in production, it was difficult to determine how much weight should be given to weather conditions rather than marketing problems or price incentives. Reports of increased trading through unofficial channels suggested that the drought had not been the sole factor responsible for the fall in output.

The impact of the drought on imports, the staff representative from the African Department continued, was indicated in Appendix Table XLI of SM/83/92. There had been a substantial increase in imports of "nondurable consumer goods" in 1981/82, mainly reflecting the increase in wheat and other consumer goods. More generally, with regard to the consistency of the projected medium-term increase in imports and the increases in investment and GDP, the staff believed that the 6 percent increase in GDP projected by the Government had been overly optimistic. In the staff's judgment, the rate of growth would be significantly less than 6 percent, and the staff's projection of imports, which took into account the projections for exports, capital flows, and the reserves target, was therefore consistent with a reduced rate of growth of GDP.

Mr. Sangare commented that the public sector investment program adopted by the Ethiopian authorities had to be considered in light of the size of the public sector and the considerable involvement and level of participation of the Government in the economy. Investment outlays had been increased to raise production and to achieve higher rates of economic growth while increasing the supply of both consumer and export commodities. The authorities were aware of the dangers of fiscal expansion arising from the investment program; they had already taken a number of measures to contain expenditure and to increase revenues. They were hopeful that recourse to domestic bank financing by the Government would be minimized.

The authorities were also seeking to expand the facilities of the banking system in rural areas, Mr. Sangare continued. They hoped that that approach would mobilize financial resources in those areas without the need to increase interest rates. The size of the increase in interest rates necessary to mobilize sufficient private sector resources could be counterproductive because it would increase the cost of production. The concerns expressed by Directors about the exchange rate were noted, particularly on the relationship of the birr to the U.S. dollar. The authorities did not attach the same importance to the issue because most of Ethiopia's imports were not denominated in dollars; however, they intended to keep the question under review.

He would convey to his authorities the recommendations of Directors with regard to the settlement of outstanding compensation claims, Mr. Sangare stated. The Ethiopian authorities were determined to resolve all the questions arising from nationalization, but some of the issues were complicated as they involved legal questions with regard to the residency status of certain companies. Final settlement would, therefore, take a little more time to resolve.

The Acting Chairman made the following summing up:

Directors agreed with the views expressed in the staff appraisal in the report for the 1983 Article IV consultation with Ethiopia. The authorities were commended for successfully carrying out the recently concluded stand-by arrangement.

Directors noted with concern the impact of the very adverse weather on the economy and on the Ethiopian population. They also viewed with concern sizable increases in the overall fiscal and balance of payments deficits. They welcomed the intention of the authorities to adopt a cautious policy with respect to bank financing of future deficits, and they stressed the need to contain fiscal deficits by restraints on nonessential outlays and by early implementation of the new tax measures presently being considered in the areas of corporate income tax and indirect taxes.

Directors cautioned that the implementation of planned investment should be supported by increased domestic resource mobilization and manageable levels of foreign borrowing. It would be important to pursue policies in those areas in conjunction with measures to improve agricultural output and productivity and with a continued policy of appropriate producer price flexibility.

It was felt that the major transformation of the economy projected in the development plan, as well as the projected growth rates of the economy and of investment, were perhaps too optimistic. Directors also believed that adjustments in domestic interest rates would be desirable.

While recognizing Ethiopia's need to improve overall growth prospects through increased public investment, Directors emphasized the importance of a sustainable external current account position and a manageable external debt burden. Noting, furthermore, the large effective appreciation in recent years of the Ethiopian birr, as a result of its peg to the U.S. dollar, they urged that economic and financial policies should give due consideration to a flexible exchange rate policy, including the possibility of a different peg for the currency, to provide support for the promotion of exports and the development of import substitutes, and to ensure that scarce foreign exchange would be used for more profitable production and investment opportunities. It was also noted that the climate for foreign financing would be improved through the full settlement of outstanding compensation claims.

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

The Executive Board then took the following decision:

Decision Concluding 1983 Article XIV Consultation

1. The Fund takes this decision relating to Ethiopia's exchange measures subject to Article VIII, Section 2, and in concluding the 1983 Article XIV consultation with Ethiopia, in the light of the 1983 Article IV consultation with Ethiopia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Ethiopia continues to maintain restrictions on payments and transfers for most current international transactions as described in SM/83/92. The Fund notes the intention of the authorities to relax the existing restrictions as the balance of payments situation improves. In the meantime, the Fund grants approval for the retention of the exchange restrictions subject to Article VIII, Section 2, until the completion of the next Article IV consultation with Ethiopia or May 31, 1984, whichever is earlier.

Decision No. 7419-(83/82), adopted
June 8, 1983

4. OIL FACILITY SUBSIDY ACCOUNT - FINAL REVIEW

The Executive Directors considered a staff paper on the final review of the oil facility subsidy account (EBS/83/94, 5/13/83).

Mr. Joyce commented that the present review stemmed, in part, from the decision taken at the time of the 1982 annual review of the oil facility subsidy account (Decision No. 7104-(82/63), 4/30/82). That decision had specified that the 1983 review would take place in April 1983. He invited the staff to comment on the reasons for the delay.

More important, Mr. Joyce continued although, the staff recommended a course of action that might not in itself be objectionable, it implied that it was the only possible option. In his view, there were a number of possibilities. In particular, the original decision setting up the subsidy account (Decision No. 4773-(75/136), 8/1/75, as amended) had contained a specific provision allowing for the termination of the account whenever the Executive Directors concluded that it was no longer necessary or that its purposes could not be carried out. The same provision went on to specify that any assets remaining at the time of closure were to be divided among the donors in proportion to their contributions (paragraph 6(b)).

His Canadian authorities were not requesting the return of their money, Mr. Joyce stressed. However, it was an option, and it was surprising that it had not been mentioned in EBS/83/94. Perhaps other possibilities also existed. For example, could the assets remaining in the account be used for other purposes? If so, was a decision by the Executive Board required? The crucial issue was not the return of the money to donors, but the importance of advising the Executive Board of all alternative possibilities so that Executive Directors could make a decision in light of all the relevant considerations.

Mr. Prowse said that he agreed with many of Mr. Joyce's points. He recalled that the Executive Board had sought a final review of the subsidy account to adequately consider alternative ways of dealing with any surplus of assets. He too had expected to find in the staff paper a more comprehensive consideration of the options available to the Board for dealing with the surplus. It would also have been appropriate upon termination of the account to have undertaken a review of its operations and effectiveness, particularly since the actual contributions had amounted to only SDR 160 million instead of the SDR 350 million originally proposed by the staff.

The first aspect of the proposed decision was the distribution of subsidy payments on purchases outstanding under the oil facility for the period May 1982 to May 1983, Mr. Prowse observed. The staff proposed that the usual 5 percent annual subsidy be paid. It appeared that no further charges would arise following the payment of charges due on July 10, 1983, although the paper was a little ambiguous in that regard. The second question was what to do with the surplus, as there was no longer a need to subsidize charges. The staff proposed that a further distribution be made retroactively to all beneficiaries to produce a uniform rate of subsidy of about 5.3 percent over the life of the account. On that question, the staff had failed to provide a range of options.

The third issue for consideration was the termination of the account once the surplus had been distributed, Mr. Prowse remarked. As Mr. Joyce had pointed out, paragraph 6 of the original decision had made provision for the termination of the account and the distribution of any surplus once the purposes of the account had been satisfied. Paragraph 6 read:

> (a) If the Executive Directors find that the subsidy account is no longer necessary or that its purpose cannot be carried out, the account will be terminated.
>
> (b) If any assets remain in the subsidy account on the date of its termination, the amount will be divided among the the donors that have made deposits in it in proportion to their contributions.

Since a surplus of about SDR 11 million remained in the account, it was surprising that the staff had not considered the position of the donors. He wondered whether donors had been consulted with respect to their attitudes to the proposal.

If the second aspect of the proposed decision was agreed upon, i.e., if the existing surplus was distributed to the beneficiaries, there would be no surplus, and the question of returning funds to the donors would be moot, Mr. Prowse went on. Therefore, the second aspect of the decision was crucial. On page 3 of EBS/83/94, the staff stated that its proposal reflected the original discussions in 1975 on the objectives of the subsidy account. He had been unable to find evidence supporting that point in the minutes of the original discussion; perhaps it had not been recorded in the minutes. However, in SM/75/197 (7/23/75), on the subsidy account, there were some relevant points. The staff paper read, in part:

> If contributions were augmented or earlier repurchases were made in any year, the Fund would make an annual review to determine whether additional amounts might be distributed to all recipients of payments, whether or not they had already repurchased, in order to increase and equalize the rates of subsidy paid and to be paid.
>
> ...To the extent that additional contributions or earlier repurchases should occur in subsequent years, further adjustments upward in the subsidy rate would be made so that, at the conclusion of the seven-year period of subsidy payments, all recipients would have received substantially the same rate over the period during which the proposed decision would be applicable.

It appeared that the case for the staff's proposal rested on that passage.

He was concerned not only about whether the Executive Board had originally envisaged a proposal along the lines recommended by the staff, Mr. Prowse commented, but also about the substance of the proposal. In that regard, there were arguments on both sides. Return of the surplus to donors would be consistent with paragraph 6 of the original decision, while the staff's recommendation to equalize the rate of subsidy to beneficiaries was consistent with the passage from SM/75/197.

It was possible that the decision to maintain the rate of subsidy at 5 percent had been too conservative, Mr. Prowse suggested, and that a larger subsidy payment would have eliminated the surplus at an earlier date. But, annual adjustment of the subsidy rate in order to eliminate the surplus might have been administratively inconvenient. It could be further argued that beneficiaries ought not to be penalized at the present stage on the basis of administrative convenience. In that sense, there were arguments in favor of the staff proposal. However, because the paper did not provide the Executive Board with options, it was difficult to accept the second and third aspects of the proposed decision. The most appropriate course of action would be for the Executive Board to approve the distribution of the payment for the period from May 1982 to May 1983 and to consider the other issues at a later date. Such consideration should include a review of the account and its operation, a review of the available options, and evidence that the latter review had been prepared in consultation with the countries whose funds were involved. At the moment, his Australian authorities favored repayment of the surplus to donors following the regular 1982-83 payment.

The Deputy Treasurer stated that the review of the subsidy account had been delayed from April 1983 in order to take into account the very small repurchases, made at the beginning of May 1983, that completed all transactions and operations under the oil facility. Therefore, the review covered the period May 1, 1982 to May 11, 1983, instead of the period to the end of the financial year, as would have been usual. The staff had believed that it would be more straightforward and convenient for the Executive Board to consider the subsidy for both 1982/83 and the first 11 days of 1983/84 together. Otherwise, the issue of the termination of the subsidy account would have been delayed for almost a full year.

The possibility that the surplus funds in the account might have been allocated for other purposes had been raised by Mr. Joyce and Mr. Prowse, the Deputy Treasurer noted. The staff had not provided a range of options because only one alternative to the one proposed was available: that no further distribution would be made and that the small amount of surplus funds would be returned to the donors in the proportion of their contributions. The staff believed that a further distribution was justified. Mr. Prowse had suggested that a review of the operations of the account might have been undertaken, focusing in particular on its size relative to the original recommendation. A review had been conducted in 1978 covering that point. The account had operated reasonably effectively with a smaller amount than originally proposed because two large industrial countries had used the oil facility but, not being among the most seriously affected countries, they had not been eligible to use the subsidy account.

At the time of the original decision establishing the account, the Deputy Treasurer recalled, it had been proposed that the rate of subsidy should be at 6 percent instead of 5 percent. Given the uncertainties regarding further contributions at the time, and the very low level of interest rates on the investment of the assets, the staff had believed that it was preferable to begin with a relatively low rate of subsidy that could be maintained throughout the life of the account rather than to start with a higher rate that might have had to be reduced. In the end, the surplus had been much higher than expected because the investment income on the balances in the oil facility subsidy account had been invested in U.S. Government securities; it had, therefore, benefited from the large increase in interest rates.

The Deputy General Counsel stated that the funds in the oil facility subsidy account had been donated to the Fund to be held by it as a trustee subject to the high standards of conduct required of a fiduciary. The funds had been donated on the understanding that they would be used strictly in accordance with the terms of the decision establishing the account. To the extent that distributions made in accordance with paragraph 3 of Decision No. 4773-(75/136) did not exhaust the amounts in the account, the funds would have to be returned to the donors. They could not be used for any other distribution, of whatever character. However, the level of the subsidy was a matter for the Executive Board to decide and there was no legal right of the donors to be consulted on that matter; if there was an amount left on termination of the account, the disposition of those funds was governed by paragraph 6(b) of the Decision.

While paragraph 6 provided for the termination of the account and the disposition of amounts on termination, the Deputy General Counsel continued, it should be recalled that subparagraph (a) had been included in large part because it had been felt there was a possibility that the account might never become operational. If that possibility had in fact occurred, the donors were assured that they would receive back their money that could not be used for the purpose of the account. If the Board decided to pay only a certain amount of subsidy and if, as a result, surplus funds remained in the account on termination, then paragraph 6(b) would apply.

The original level of the subsidy had been set in light of the requirement of paragraph 3(b), the Deputy General Counsel added, which stated:

> To the extent that it proves financially possible, the Fund will equalize the percentages payable to all recipients during the period of payments under this Decision.

At the beginning it had been recognized that it would be easier to accomplish the equalization of the percentages by starting off with a modest rate of subsidy that could be increased prior to the termination of the account rather than starting with a higher rate of subsidy that might have had to be reduced, with resulting unequal payments to beneficiaries.

Mr. El-Khouri said that it remained unclear why the staff paper had made no reference to paragraph 6(b) of the original decision.

The Deputy General Counsel replied that the omission had been inadvertent.

Mr. Taylor said that Mr. Joyce and Mr. Prowse had made a number of valid points. He agreed that it would have been helpful to have the alternatives clearly stated in the paper, particularly as both alternatives were specifically mentioned in the original decision. However, he could accept the staff's recommendation that the surplus be distributed retroactively to all the beneficiaries in proportion to their eligible use of the facility. It was a sensible and appropriate use of the remaining resources.

Mr. Grosche said that he could accept paragraph 1(i) and (ii) of the proposed decision. However, it might be more appropriate to use the surplus funds to strengthen the subsidy account of the supplementary financing facility.

The Acting Chairman commented that, legally, that option was not open. It might be possible to terminate the account, returning the surplus to the donors who might then wish to make additional contributions to the supplementary financing facility subsidy account. That would be their decision, and, in some cases, it might require domestic legislative approval.

Mr. Jaafar remarked that he agreed with Mr. Joyce and Mr. Prowse that alternative options should have been considered. Furthermore, if a review of the effectiveness of the account was to be undertaken, it should consider the possibility that a subsidy higher than 5 percent might have been appropriate. He could support the proposed decision.

Mr. Yamashita commented that he could support the proposed decision. However, he sympathized with the concerns expressed by Mr. Joyce and Mr. Prowse. The staff could have covered a wider range of options, even if the final conclusion might have been the same.

Mr. Alhaimus also supported the proposed decision. He agreed that it would have been more helpful if all options had been explored.

Mr. Wang commented that, although he agreed with many of the points made by Mr. Joyce and Mr. Prowse, he could support the proposed decision.

Mr. Péroz, Mr. Portas, Mr. Robalino, Mr. Jayawardena, Mr. Delgadillo and Mr. Sangare each said that he could support the proposed decision.

Mr. Lovato stated that he also could support the proposed decision, although the points raised by Mr. Joyce and Mr. Prowse had been valid.

Mr. Schuijer remarked that he did not object to the proposed decision. Perhaps if any individual donor wished to receive its money back the claim could be honored, since the original decision had provided for that option.

The Acting Chairman observed that it was not possible to honor individual claims.

Mr. El-Khouri said that he also could support the proposed decision. His earlier comment should not be misinterpreted to mean that his authorities wished to receive back part of the contribution that they had made to the oil facility subsidy account. He had simply wished to make the point that a number of options should have been presented in the staff paper.

Mr. Joyce stated that he also supported the proposed decision. However, he strongly supported Mr. Prowse's suggestion that a review of the operations and effectiveness of the subsidy account be undertaken. The lessons could prove valuable if similar circumstances should arise again. Perhaps the proposed decision could be taken in two steps, along the lines suggested by Mr. Prowse.

The Acting Chairman agreed that the decision could be taken in two parts. First, Directors would agree now to the first part of the proposed decision, namely, to pay the 5 percent subsidy for the period from May 1, 1982 to May 11, 1983. The remaining elements in the decision--to distribute an additional 0.32 percent to the beneficiaries, and to terminate the oil facility subsidy account--would be taken on a lapse of time basis. The staff would issue an additional paper reviewing experience with the account. The decision on the disposition of the remaining assets in the subsidy account and on the termination of the account would be included in that paper, in accordance with the understanding reached at the present meeting.

The Executive Directors then adopted the following decision:

1. Subsidy payments shall be made to the beneficiaries listed in Table 2 of EBS/83/94, on the average daily balances of the Fund's holdings of each member's currency subject to charges that were outstanding under the 1975 oil facility (Executive Board Decision No. 4634-(75/47), as amended), and eligible for subsidy for the period from May 1, 1982 to May 11, 1983, at the rate of 5 percent per annum.

2. The payments shall be made in U.S. dollars on June 15, 1983, to the beneficiaries that have paid the charges due as of the end of April 1983, in connection with the 1975 oil facility.

3. No charge shall be levied for the services rendered by the Fund in the administration and operation of the subsidy account.

Decision No. 7420-(83/82), adopted
June 8, 1983

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/81 (6/3/83) and EBM/83/82 (6/8/83).

5. FUND NET INCOME FOR FINANCIAL YEAR 1983

The Executive Board took note of the change in net income reported in EBS/83/75, Supplement 2, and reaffirmed the decision adopted at EBM/83/70 (5/16/83) to place the net income to the special reserve and to continue the present rate for charges, remuneration, and interest on the SDR. (EBS/83/75, Sup. 2, 6/3/83)

Decision No. 7421-(83/82), adopted
June 7, 1983

6. AFGHANISTAN - 1983 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to postpone its consideration of the 1983 Article IV consultation with Afghanistan until not later than June 22, 1983. (EBD/83/158, 6/1/83)

Decision No. 7422-(83/82), adopted
June 3, 1983

7. SOUTH AFRICA - 1983 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to postpone consideration of the 1983 Article IV consultation with South Africa until not later than June 20, 1983. (EBD/83/155, 6/1/83)

Decision No. 7423-(83/82), adopted
June 3, 1983

8. ANNUAL REPORT ON EXCHANGE ARRANGEMENTS AND EXCHANGE RESTRICTIONS, 1983 - PART ONE

The Executive Board approves the report set forth in SM/83/62, Revision 1 (5/27/83).

Adopted June 3, 1983

9. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/148 (6/2/83) and EBAP/83/149 (6/3/83) is approved.

10. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/83/150 (6/3/83) is approved.

APPROVED: October 20, 1983

LEO VAN HOUTVEN
Secretary