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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/158

3:00 p.m., November 21, 1983

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

Executive Directors	Alternate Executive Directors
	A. Kone, Temporary
	G. Ercel, Temporary
B. de Maulde	
	C. A. Salinas, Temporary
R. D. Erb	J. C. Williams, Temporary
M. Finaish	T. Alhaimus
	H. Kobayashi, Temporary
J. E. Ismael	
	D. I. S. Shaw, Temporary
	C. Robalino
	G. Grosche
	C. P. Caranicas
R. N. Malhotra	
	J. E. Suraisry
J. J. Polak	T. de Vries
	K. G. Morrell
	A. Yasseri, Temporary
	E. I. M. Mtei
M. A. Senior	J. L. Feito
J. Tvedt	
	T. A. Clark
Zhang Z.	

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

Also Present:
B. Legarda, Consultant. European Department: L. A. Whittome, Counsellor and Director; P. de Fontenay, B. de Schaetzen, P. Dhonte, V. Marie, J. S. Van't dack. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; M. Guitian. Fiscal Affairs Department: A. L. Antonaya, C. Schiller. Legal Department: J. K. Oh, S. A. Silard, J. V. Surr. Middle Eastern Department: A. S. Shaalan, Director; M. Arif, F. Drees, B. A. Karamali, A. Kayoumy, K. Nashashibi, E. M. Taha, G. Tomasson. Western Hemisphere Department: C. Cha, R. A. Elson, M. R. Figuerola, T. F. Lewhing, G. Oliveros. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. R. Abiad, J. R. N. Almeida, S. El-Khouri, P. D. Péroz, M. Z. M. Qureshi. Assistants to Executive Directors: J. Bulloch, M. B. Chatah, R. J. J. Costa, M. Eran, I. Fridriksson, G. Gomel, V. Govindarajan, D. Hammann, N. U. Haque, C. M. Hull, J. M. Jones, G. W. K. Pickering, E. Portas, A. A. Scholten, Shao Z., S. Sornyanyontr.

1. JORDAN - 1983 ARTICLE IV CONSULTATION

Executive Directors considered the staff report for the 1983 Article IV consultation with Jordan, together with a proposed decision (SM/83/206, 10/13/83; and Cor. 1, 11/3/83). They also had before them a report on recent economic developments in Jordan (SM/83/220, 11/1/83).

Mr. Finaish made the following statement:

As shown by the staff report, Jordan (the West Bank not included) experienced buoyant economic activity during 1976-81, with real GDP growth averaging about 9 percent annually. An important contributory factor to this performance was a large inflow of resources in the form of workers' remittances and economic assistance from other Arab countries, supported by domestic policies aiming at an efficient utilization of these resources. At the same time, recognizing the sensitivity of the budgetary and balance of payments positions to external flows, the authorities intensified their efforts, within the framework of development planning, toward diversifying the productive base, promoting exports, and mobilizing domestic resources.

The period since early 1982, however, has been marked by a number of adverse developments, which have prompted major domestic and external adjustments. The slowdown in economic activity in neighboring oil exporting countries precipitated a pronounced decline in the growth of exports and workers' remittances. At the same time, foreign grants fell short of their expected levels. In response, the authorities have adopted a number of measures in order to avoid large imbalances and to minimize any disruptive impact that these developments might have on the process of growth and development. These measures enabled the economy to continue to grow at a healthy rate of 5.5 percent in 1982, with inflation remaining moderate.

Faced with the fiscal implications of a substantial shortfall in foreign grants, which accounted, on average, for as much as 43 percent of budgetary receipts during 1976-81, the authorities responded promptly and decisively with expenditure cuts and measures aimed at raising domestic revenues. Public investment projects not directly productive were postponed. As a result, capital expenditures in 1982 were reduced by about 38 percent from their budgeted levels. Other measures aimed at containing the growth of current expenditures were also adopted, including the deferral of cost of living adjustments in civil service salaries. On the revenue side, and in addition to discretionary tax increases incorporated in the 1982 budget, tariffs on ports and other services were increased. The effect of these and other measures has been an overall deficit 29 percent lower than the level estimated in the budget.

This policy of fiscal restraint has been continued beyond the 1982 budget. Additional revenue-raising measures, including a newly introduced capital gains tax on real estate sales and higher tariffs on imports of certain luxury items, are expected to increase domestic revenues by more than 19 percent in 1983. This, coupled with continued restraint in current and capital expenditures, is expected to reduce the budget deficit to its lowest level since 1977, with domestic revenue accounting for about 92 percent of current expenditures. Although this policy of expenditure restraint may cause a departure from investment outlays envisaged in the 1981-85 Development Plan, the authorities do not view this with much concern, since the Plan is regarded as a broad statement of investment priorities rather than a rigid set of targets. Hence, while adhering to the overall objectives of the Plan, they intend, in the period ahead, to continue to exercise flexibility in its implementation.

The focus of the Central Bank's credit policy during 1982 and the first half of 1983 was on three main objectives: (a) responding to the impact on domestic liquidity of the decline in foreign grants and the slowdown in workers' remittances, (b) encouraging financial institutions to purchase Treasury bills as a means of financing part of the fiscal deficit, and (c) strengthening the Bank's credit regulatory instruments. A number of measures were taken toward these objectives, including the introduction of a reserve requirement on large deposits with investment banks and finance companies, to be held in the form of Treasury bills, and a lower reserve requirement on commercial bank deposits invested in the new issues of government bonds.

Despite the significant slowdown in economic activity in 1982, domestic liquidity expansion decelerated only marginally from its 1981 rate, with claims on government increasing much faster than claims on the private sector. In 1983, however, it is expected that growth in monetary aggregates will be more in line with the policy of economic and financial restraint pursued by the authorities. With a substantial decline in the bank-financed budget deficit, liquidity expansion is estimated to have slowed down significantly in the first half of 1983.

The sensitivity of Jordan's external payments position to fluctuations in foreign grants and workers' remittances was again manifested in 1982. In addition to these two factors, current receipts were also adversely affected by a much slower growth in exports due to the worldwide recession and regional difficulties affecting Jordan's principal export markets. On the payments side, the adjustment of expenditures during 1982 played a significant role in reducing the rate of import growth to a modest 9 percent compared with 46 percent in 1981. This, however, did not prevent substantial deficits in both the current and the overall accounts. The continued restraint in government expenditures and the efforts undertaken to expand the markets for

Jordanian exports are expected to moderate the increasing pressures on the current account in 1983. An increase in capital inflow in the form of foreign loans, which took place earlier this year, will help reduce the overall deficit by more than 80 percent from its 1982 level. Although the ratio of debt service to exports of goods and services has been relatively low at about 6 percent, and in line with the general policy of increasing the reliance of the economy on domestic resources, the authorities intend to follow a cautious policy with respect to external borrowing.

In conclusion, the authorities have responded well to the changing economic environment in the past two years. While consolidating the gains already made in the areas of economic and social development and mobilization of domestic resources, they have adopted commendable policies toward economic adjustment. These policies are indicative of the willingness and ability of the authorities to undertake the adjustments necessary to steer the economy through an admittedly difficult period, while maintaining a liberal exchange and trade system.

Finally, the present staff report, like many previous ones on Jordan, continues to have the limitation of excluding from the analysis economic developments on the West Bank and their implications for the Jordanian economy. While noting the discussion on the matter at the Board meeting on the 1982 Article IV consultation with Jordan, the authorities feel that their viewpoint should remain under consideration by the Fund.

Mr. Suraisry said that he was in general agreement with the staff analysis and supported the proposed decision. Despite adverse external conditions, the performance of the Jordanian economy--without the West Bank--had been quite satisfactory in 1982. Achieving a growth rate of real output of 5.5 percent, in a year that success had been difficult for almost every country, was commendable. Like the staff, he believed that that achievement was the product of a well-coordinated policy. For 1983, the staff projected the same rate of growth, mainly as a result of higher industrial and agricultural output. Since fiscal expenditure was expected to be under restraint, that projection assumed a higher demand for Jordanian exports by neighboring countries in 1983 than in 1982. However, those countries were laboring under the same economic conditions as in 1982 and were still making the same adjustment efforts. It seemed to him, therefore, that the projected growth rate might turn out to be optimistic unless the staff had another scenario in mind.

Referring to fiscal policy, Mr. Suraisry noted that due to a large shortfall in foreign grants, the authorities had taken strong adjustment measures. Expenditures had been reduced and revenue increased. He commended the authorities for those efforts, which seemed, in Mr. Finaish's words, to be "indicative of the willingness and ability of the authorities" to adjust. It was clear, however, that the economy was very dependent on foreign assistance. Any effort to reduce that dependence was, needless to say, of great importance. He noted with satisfaction the efforts being made through the development plans to diversify the economy. Further economic diversification was a necessary condition for lessening dependence on foreign assistance. The results achieved so far were mainly due to the Government's endeavors to enhance and promote the role of the private sector. In that connection, he hoped that the World Bank's study on how to promote manufacturing exports would turn out to be helpful.

The stance of monetary policy was generally consistent with overall economic policy, Mr. Suraisry considered. The rate of domestic liquidity expansion was expected to decline from 19 percent in 1982 to about 14 percent in 1983, and credit to the private sector was expected to decline only marginally. However, domestic financing in 1982 had been more than estimated in the budget. While the expansion had been made necessary by the unexpected shortfall in foreign grants, it was a short-term solution, and he was pleased to note that both the authorities and the staff expected domestic financing to be reduced in 1983.

The external sector was, as the staff said, subject to developments beyond the authorities' control, Mr. Suraisry continued. For the time being, Jordan had the option of relying on further external borrowing. Its outstanding external debt and debt service were both still low, although the rapid rate of increase meant that the authorities would need to exercise caution in contracting further external debt, as they were aware. He welcomed their intention to limit new external borrowing to what was needed to repay maturing outstanding debt. Finally, the Jordanian authorities deserved commendation for maintaining a liberal exchange and trade system.

Mr. Williams remarked that his authorities were in general agreement with the staff appraisal and supported the proposed decision. Faced in 1982 with a significant decline in external grants, the Jordanian authorities had undertaken a series of adjustments with respect to fiscal policies that were designed to maintain equilibrium in the external accounts. Although the actual budget deficit had been held to 6.3 percent of GDP, which represented a 28.6 percent reduction from the original budget deficit, the overall balance of payments had registered a deficit for the first time in several years. Fiscal policies would be further tightened in 1983, which, with appropriate complementary policies, should result in a substantially reduced balance of payments deficit. Nevertheless, such an outcome would result in a further weakening of Jordan's reserve position, especially when measured against average imports. Thus, while reserve levels would continue to be relatively comfortable, the trend was potentially a source of concern.

It would be helpful if the staff or Mr. Finaish could produce more recent estimates of foreign grant receipts for 1983, Mr. Williams stated. His authorities were concerned that roughly two thirds of the expected shortfall noted on page 6 of SM/83/206 would be met by increased domestic financing. However, the proposed domestic financing would equal the average of the three years prior to 1982 and, if held to that level, would not appear to be unduly worrisome. Did the authorities have contingency adjustment plans in case there was a further reduction in grants? Had inflationary pressures increased as a result of the high level of domestic financing of the 1982 deficit? If so, should an even more restrictive monetary and credit policy be adopted in 1983?

The Jordanian authorities should indeed continue to exercise prudence in contracting external debt on commercial terms, Mr. Williams said. In view of the rapid buildup in external debt, could the staff give an indication of projected debt service beyond 1983?

Mr. Grosche remarked that Jordan had experienced a rate of growth--more than 5 percent--that was seldom found nowadays. The domestic public sector deficit was being reduced at an impressive speed, thanks to stringent expenditure policies, and the recently emerging deficit on the overall balance of payments would obviously disappear at almost the same speed with which it had appeared. The rate of price increase remained within reasonable limits, and the Government was providing, as the staff put it, a strongly supportive environment for private sector activity and initiative.

Nevertheless, Mr. Grosche continued, his impression was that the staff had not questioned very searchingly the views put forward by the authorities. For instance, did the staff fully concur with the opinions of the authorities on monetary developments? Conceivably, monetary policy could have made a contribution toward a further abatement of the inflation rate. He also sought clarification of the statement on page 7 of SM/83/206 that commercial banks and other financial institutions were to be encouraged to buy Treasury bills, mainly by means of compulsory reserve requirements, a certain proportion of bank deposits having to be invested in government securities. He would be interested in the staff's view on whether or not such a policy would lead to an undesirable confusion of monetary and fiscal policies. He also questioned the usefulness of stronger central bank control over the sectoral allocation of credit in the economy. Structural policies should, in his view, be implemented through fiscal policy.

There were few projections for the main economic aggregates in the staff report, Mr. Grosche observed. He asked whether any further information was available about the rate of growth in 1983, and the prospects for 1984.

He shared the preoccupation of the staff with the development of Jordan's external indebtedness, Mr. Grosche concluded. He hoped that the experience of other countries would help the authorities to avoid taking full advantage of the flexibility they still had to engage in further external borrowing.

Mr. Yasseri said that in the past several years, and prior to 1982, the Jordanian economy had shown continuous growth, mainly supported by a strong environment for private sector activities and supportive financial policies. Adequate levels of foreign grants and of inward workers' remittances had had favorable effects on the external sector. The Five-Year Plans for 1976-80 and 1981-85 had had, as principal objectives, the maintenance of high growth rates, the reorientation of the economy toward the export sector, less dependence on foreign grants, and the expansion of social services.

During 1982 and 1983, external developments had adversely affected key sectors of the economy, Mr. Yasseri continued. Some of Jordan's major donors and/or purchasers of its goods, services, and labor, had themselves come to need external financing. The reduction in capital expenditure to cope with a lower flow of external aid, and the world economic recession, had aggravated the gradual, unfavorable turn of events. Nevertheless, the authorities had managed to take early measures to isolate the economy from some of the unfavorable effects.

The outlook for the few years ahead would depend on the levels of economic activity in neighboring Arab countries and Persian Gulf states, continued revival in world economic activity, and the maintenance of the flow of foreign credits and grants and of workers' remittances, Mr. Yasseri observed. With the appropriate adjustment measures already adopted by the authorities, adverse external effects should prove minimal. But much caution would be needed to deal with unforeseen developments in the external sector. For the first time in several years, a deficit in the overall balance of payments had been recorded. Both exports and workers' remittances had shown reduced growth rates, compared with 1981. A projection of interest and amortization payments for the coming five years indicated that annual payments would rise substantially in the next three years before leveling off in 1986.

The stance of fiscal policies had become contractionary in 1982, an acknowledgement of reduced aid flows, Mr. Yasseri remarked. In addition to cutting capital expenditure, the authorities had reinforced control over current expenditure. In the light of uncertain revenue prospects for 1983 and beyond--despite high domestic tax revenue--budgetary prospects would focus on the continued pursuit of stringent spending policies. The overall budget deficit was expected to be halved in 1983.

The highlights of monetary developments in 1982 were an increase in the claims of the banking system on the Government and a considerable decline in net foreign assets, both necessitated by reduced aid and revenue flows, Mr. Yasseri commented. The stance of monetary policy was expected to continue to be tight in compliance with the uncertain revenue prospects. Thus, the authorities had taken adequate fiscal and monetary measures to deal with upcoming changes in inflows of external resources.

Finally, Mr. Yasseri stated, he had no difficulty in supporting the proposed decision. There had been a delay in the repayment by Jordan of financial obligations due to the Islamic Republic of Iran, despite several reminders from the authorities in Teheran through different and proper channels. He had already been in contact with the staff and Mr. Finaish's office on the question, and he hoped that prompt payment of due debt and the fulfillment of all loan obligations would truly qualify Jordan as a country having a liberal payments policy.

The staff representative from the Middle Eastern Department explained that the staff had itself been of the view that the estimate for a rate of growth of GDP in 1983 of 5-6 percent might be on the high side, considering the continued slack in neighboring economies and in world demand for Jordanian products. However, the authorities had pointed out that the relatively high rate of growth reflected in part the expectation of a favorable agricultural crop because of good rainfall. Furthermore, a number of major industrial projects had been in the process of coming on stream in late 1982 and would continue to increase their productive capacity in 1983. In light of those explanations, the staff had not felt it necessary to make explicit reservations about the growth projection. Partly because of the uncertainties with respect to output performance in 1983, the staff had not made output growth projections for 1984.

The Jordanian authorities did indeed need to be vigilant and stand ready to constrain financial policy should there be further adverse developments in receipts from external grants, the staff representative said. The decline in the proceeds from external grants between 1981 and 1983 had been substantial in terms of GNP, and, in response, the authorities had acted to curtail the ratio of total government expenditures to GDP by some 5 percentage points over the two years. That curtailment had represented a major adjustment effort, and the Jordanian authorities had made it clear to the mission that their present financial policy stance had been formulated in light of their expectations with respect to grant receipts in the coming months. Moreover, they had also made it clear that if those expectations proved optimistic, they were determined to take whatever corrective action was indicated.

The policy stance of the authorities with respect to foreign debt financing of the public sector had been discussed by the staff only in general terms, the staff representative continued. At the time of the mission, the authorities had been engaged at the cabinet level in reviewing a detailed study undertaken by the Central Bank, the Ministry of Finance, and other agencies of the country's external debt situation and debt management policy for the medium term. Because the issue was under active consideration by the Government, with a view to formulating policy, the staff had undertaken no specific debt projections beyond 1983 other than to note that, on the basis of present expectations, the debt service ratio was not likely to prove bothersome in the medium term.

Some of the uncertainty relating to the external picture translated into corresponding uncertainty with respect to monetary and financial developments, the staff representative continued. The staff had felt that the endeavors of the Government to contain the growth of current expenditures and to curtail capital expenditures in line with the availability of external grants had been quite successful. Therefore, the staff had seen no substantive grounds for questioning the official estimate of the Government's domestic financing requirements for 1983, and monetary data through August suggested that fiscal performance in the first part of the year had been consistent with the staff's evaluation at the time of the mission. The single most exceptional development revealed by monetary data through August was the relatively strong performance of net foreign assets. Whereas the authorities had been projecting an overall external deficit of JD 31 million for the year as a whole, monetary data indicated a considerable surplus of about JD 20 million in the first eight months of 1983. Accordingly, the overall growth of liquidity had been somewhat higher than expected. However, the liquidity projection for the full year could not be based on the experience of only the first eight months because of the uneven timing of receipts of foreign exchange and certain external payments. Overall, monetary developments in 1983 were not likely to be significantly worse than projected at the time of the mission.

The requirement that certain financial institutions acquire Treasury bills and bonds in a certain proportion to their deposit liabilities should be viewed, the staff representative considered, in the context of the authorities' endeavor to limit the extent to which commercial banks maintained net foreign asset positions abroad. The authorized ratio of foreign deposits to foreign liabilities had been reduced by 10 percent in October 1982, and the change in Treasury bill purchase requirements had been seen partly as a means of compensating commercial banks for the loss of revenue resulting from the curtailment of their ability to maintain balances abroad.

The delays in certain payments between Jordan and Iran were not, according to the staff's understanding, the result of restrictions on current transactions and would not thus fall directly under the Fund's jurisdiction, the staff representative from the Middle Eastern Department explained. At the time of the Annual Meeting, the staff had suggested making available its good offices, if that would help to facilitate settlement of the issue, but there had been no result so far.

Mr. Finaish remarked that the Jordanian authorities were of course aware of the sensitivity of the budget and the balance of payments to external flows, including remittances, foreign grants, and exports. They would continue the policy of trying to diversify the economic base of the country in order to encourage exports and mobilize domestic resources. For a long time, the authorities had attached special importance to the adequacy of international reserves, owing to the sensitivity of the balance of payments and of external flows, which could vary substantially from year to year. At the end of 1982, gross reserves had stood at more than 6.5 months' imports.

Although external debt had been rising in recent years, Mr. Finaish commented, the debt service ratio had been kept close to 6 percent. The recently contracted Eurodollar loan--for $225 million--had been prompted by the shortfall in foreign grants and prefinancing by the Central Bank. The oversubscription of the loan indicated Jordan's good credit rating abroad. In any event, the authorities intended to resort to foreign borrowing only to ease the impact of settling relatively large debt obligations falling due in the coming two years.

In response to Mr. Yasseri's question, which had been raised with him only recently, Mr. Finaish explained that when his office received the additional information, he would convey it to his Jordanian authorities.

The Chairman made the following summing up:

> Executive Directors were in general agreement with the views contained in the staff report for the 1983 Article IV consultation with Jordan. The Jordanian authorities had been faced with a major task of economic adjustment in 1982 because of a decline in external grant receipts from the levels of recent years. Thanks to the firm and effective response of the authorities, however, the Jordanian economy had recorded a solid increase in real output in 1982 without sacrifice of reasonable domestic and external financial equilibrium.
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> Directors observed that fiscal policy had played a central role in the adjustment effort in 1982, with current expenditure growth severely restrained, and with capital outlays substantially below original budget estimates. Domestic revenue had exceeded the original target owing to intensified collection efforts and higher tax rates. Directors noted that the basic stance of fiscal policy remained unchanged in 1983, as external grant receipts were projected to record a further substantial decline. The question was raised whether monetary policy was contributing adequately to the Government's stabilization objectives.
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> Directors noted that Jordan's balance of payments had been in overall deficit in 1982 for the first time in several years, and that a deficit was also in prospect for 1983. In the medium term, Directors suggested that Jordan's external payments position would need to be strengthened by a continuation of the rapid export growth of recent years. Although the level of Jordan's outstanding debt and debt service obligations was relatively low, Directors agreed with the position of the authorities that care should be exercised in the contracting of external debt at market rates by Jordan. In this connection, Directors also commended the emphasis placed by the Jordanian authorities on the promotion of manufacturing for exports and on domestic resource mobilization through the government budget as a means of moderating the economy's vulnerability to changes in external grant receipts.
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> It is expected that the next Article IV consultation with Jordan will be held on an 18-month cycle.

The Executive Board then took the following decision:

Decision Concluding 1983 Article XIV Consultation

1. The Fund takes this decision in concluding the 1983 Article XIV consultation with Jordan, in the light of the Article IV consultation with Jordan conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that Jordan continues to operate a liberal exchange system and welcomes the termination of a bilateral payments arrangement with a Fund member.

Decision No. 7560-(83/158), adopted
November 21, 1983

2. KINGDOM OF THE NETHERLANDS - NETHERLANDS ANTILLES - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with the Netherlands Antilles (SM/83/222, 10/31/83). They also had before them a report on recent economic developments in the Netherlands Antilles (SM/83/226, 11/4/83).

Mr. Polak made the following statement:

Although the population of the Netherlands Antilles is less than 250,000 (with 150,000 people living on Curaçao, 60,000 on Aruba, 10,000 on Bonaire and 15,000 on the three Windward Islands some 600 miles to the north) the six islands differ greatly from one another. Each has a different cultural and historical heritage, which affects both their present economic situation and their future potential. It is to be noted that these differences have now resulted in a constitutional change that by 1986 will give Aruba a separate status within the Kingdom of the Netherlands. Full independence for Aruba is foreseen in principle for 1996. The Antilles already enjoy a large measure of independence, the link with the Netherlands, apart from development assistance, foreign affairs, and defense, being mainly a psychological one.

As for economic structure, Curaçao is the old trading and government center with the most varied economic base, consisting primarily of oil processing, an offshore financial sector, tourism, and a drydock. On Aruba, tourism is more important than on Curaçao, and the island similarly possesses oil refinery capacity. The mainstay of St. Maarten, the most important of the Windward Islands, is tourism. The government sector constitutes an important source of employment on all six islands.

At present the aggregate budgetary position of the five governments--a Federal Government, one island government for each of the three larger Leeward Islands, one for the three Windward Islands--is satisfactory, and the same is true for the balance of payments. However, this is a temporary situation. As taxes are collected with a considerable time lag, the present high level of receipts from foreign oil companies and the offshore financial sector results from the favorable circumstances of 1979-81. A turn for the worse is thus imminent.

Structurally there has been a tendency for public expenditures to grow more rapidly than tax receipts. Curaçao, moreover, has to bear the severe adverse effects of an almost complete cessation of tourism from nearby Venezuela. As the Venezuelan tourists traditionally went on a shopping spree on Curaçao, the consequences of their absence are rather widely felt on the island.

These developments have been thoroughly analyzed by the staff. Because it has also become apparent that, in the changed world economic situation, wages have become uncompetitive, the Federal Government, the Central Bank, and the major enterprises are in the midst of devising needed adjustment measures. On November 16, the Federal Government announced a series of tax increases. The profit tax is to rise from 40 percent to 48 percent. Import duties on luxury consumer durables like video equipment, radios, cars and yachts, are to rise from 22 percent to 40 percent, and an increase in the exise taxes on gasoline, tobacco, and alcohol has been announced. Moreover, in August the Government increased the tax on exchange transactions from 0.8 percent to 1.3 percent, and it is now considering a further increase to 2 percent. This is a somewhat controversial measure as it introduces incentives in favor of foreign exchange transactions outside the banking system to excape the tax. On St. Maarten, it moreover further encourages the already widespread use of the dollar for local payments instead of the Antilles guilder.

In the field of monetary policy, the Central Bank has imposed a freeze on consumer credit, the total of which on January 31, 1984, is not to exceed the level reached on October 31, 1983.

In the field of wages, an important agreement has been reached in the drydock. Confronted with a choice between large-scale dismissals and a reduction in wages, workers accepted a general wage reduction of no less than 23 percent. The oil refinery on Curaçao has also reduced real wages, although with more difficulty. After protracted negotiations and the imposition of a cooling-off period by the Federal Government, the refinery has abolished, as of November 10, 1983, both indexation and vacation allowances, the latter being equivalent to 6 percent of annual wages. The Government is known to be considering abolishing vacation allowances as well from January 1, 1984 onward.

Thus, an important, although necessarily difficult, beginning is being made with the reduction of real wages and the deficit of the Federal Government, and the measures taken so far go clearly in the direction already indicated by the staff some months previously. This effort must now be extended; wage moderation will have to spread to the other economic sectors. Public finances could be further strengthened by greater attention to expenditure and expenditure control as well as to tax collection. There is a five-year backlog in the assessment of personal income taxes.

The authorities have, quite rightly, concluded that, for an economy as open as that of the Netherlands Antilles, no purpose would be served by a change in the exchange rate without prior agreement on the acceptance of a reduction in real wages, and that, once such a reduction has been brought about, an exchange rate change would be redundant. For a country that has the benefit of a traditionally fixed exchange rate on a major currency, in the Antilles the U.S. dollar, a light-hearted change in the traditional exchange rate relationship in the face of the need for a relatively small adjustment in real wages, is as little warranted as was the tendency to maintain fixed exchange rates at almost all costs in the 1950s and the 1960s.

The Netherlands Antilles have for centuries made a living by exploiting the ever-changing opportunities provided by the circumstances of the moment in international trade, services, and finance. If one or the other of the current mainstays of economic activity were to become less lucrative, the likelihood is that new economic opportunities would be discovered, as in the past.

Mr. Polak added that, apart from the measures of adjustment taken in the past several days, the Central Government had, on November 18, decided to abolish the indexation of all salaries and vacation allowances, the latter amounting to an important reduction in money wages.

Mr. Erb considered that the external conditions facing the Netherlands Antilles suggested that the fiscal adjustments put in place by the authorities were warranted. He had been pleased to hear Mr. Polak's report of further action along those lines. More generally, he would agree with Mr. Polak that a downward adjustment in real wages was a more desirable approach to improving the international competitiveness of the Netherlands Antilles than an exchange rate change. As pointed out in the staff report, the open financial and trade system meant that if the authorities were to begin to allow inflation to result in frequent exchange rate adjustments, there would no doubt be a significant negative feedback on the behavior of those making financial decisions, thereby probably weakening the international financial role of the Netherlands Antilles.

Given the importance of domestic monetary management in enabling the Government to avoid the need for exchange rate adjustments, the uncertainty surrounding monetary financing of the Central Government was of some concern, Mr. Erb continued. Along with the staff, he urged the development of specific arrangements between the Central Government and the island governments regarding the rate at which they would have recourse to monetary financing, and notably regarding the use of the island governments' large creditor balances with the banking system. It was commendable that the Netherlands Antilles had not relied on commercial debt and was not burdened by commercial debt service. Additional prudent management measures at the present time should prevent potential problems from materializing.

As for the offshore financial sector, Mr. Erb noted, the staff had mentioned that renegotiation of the tax treaty with the United States was creating uncertainty about the prospects for investment in that sector. The United States was anxious to resolve the issues that had prompted the renegotiation.

Because those issues were not mentioned in the staff report, Mr. Erb explained that of primary concern to the United States was the widespread practice by residents of third countries of establishing entities in the Netherlands Antilles for use as vehicles to channel investments into the United States. Through such entities, third-country residents derived income from those investments at favorable tax rates under the U.S.-Antilles tax treaty. Those treaty provisions, the relatively low Antilles tax burden on the entities, and an absence of Antilles taxes on payments to the third-country investors, combined to make the Antilles an attractive place for third parties seeking to invest in the United States. Therefore, the United States considered it necessary to limit the third-country provisions of the treaty.

A second feature of the negotiation was that the United States was requiring inclusion of more comprehensive provisions for the exchange of information, Mr. Erb said. They were necessary to ensure that U.S. tax benefits were not going to persons not entitled to them, and that U.S. taxes were not being evaded through transactions involving the Antilles. Such provisions had to include access to tax information on bank and corporate ownership that was not provided under the current treaties. In sum, his authorities would like to see a speedy conclusion of the negotiations to reduce any unnecessary uncertainties surrounding the offshore financial sector.

The staff representative from the European Department remarked that measures taken recently in the Netherlands Antilles were encouraging. Already in 1979, the Antilles had been exposed to a difficult fiscal situation, to which they had reacted flexibly. The measures taken in the past few days were a sign of continued flexibility, which boded well for the future.

Mr. Polak expressed appreciation for Mr. Erb's elaboration of the issues still to be resolved in the tax treaty between the Netherlands Antilles and the United States.

The Chairman made the following summing up:

It was noted that activity in most sectors of the economy had shown signs of weakness since late 1982, which could be ascribed not only to a decline in external demand but also to somewhat uncompetitive labor costs.

In view of the present and prospective employment difficulties, the social partners and the authorities should be commended for seeking to restore wage competitiveness; the moderation, or even reduction in some cases, of wages, and the abolition of certain wage indexation arrangements, were welcome.

It could be anticipated that external developments might well imply a stabilization and perhaps decline of public sector revenues, a prospect that had to be contrasted with the rising trend of expenditures. Thus, a warning should be given of the threat of rapidly rising fiscal imbalances, which could undermine rather quickly the external position of the Netherlands Antilles. The tax measures announced by the Federal Government on November 16 should therefore be welcomed.

Article IV consultations with the Netherlands Antilles will continue to be held on an 18-month cycle.

3. HONDURAS - 1983 ARTICLE IV CONSULTATION

Executive Directors considered the staff report for the 1983 Article IV consultation with Honduras (SM/83/224, 11/1/83). They also had before them a report on recent economic developments in Honduras (SM/83/233, 11/14/83).

The staff representative from the Western Hemisphere Department said that, on the basis of summary banking system data through early November, Honduras's deviation with respect to the ceiling on credit to the nonfinancial public sector under the present stand-by arrangement had continued to increase. Furthermore, the staff had recently been informed of a change in the system of import licencing that was in effect until the end of 1983. As of November 14, 1983, the Central Bank of Honduras had decided that import permits would be granted freely in those cases in which payments would be made with own exchange, namely, without recourse to foreign exchange sold through the domestic banking system. In relation to the previous regime, that change might be a step in the right direction, but the modification of the existing import licensing system constituted an exchange restriction subject to the Fund's jurisdiction under Article VIII.

Mr. Senior made the following statement:

I would like to express the appreciation of my Honduran authorities for the excellent work done by the recent Fund mission in relation to the 1983 Article IV consultation. My authorities value highly the Fund's advice and have maintained close consultations with this institution for a long time. As Directors know, Honduras entered into a three-year extended arrangement with the Fund in mid-1979, followed by the current 14-month stand-by arrangement approved in November 1982. Both of these arrangements, although admittedly with mixed results, have served Honduras well and have contributed significantly to frame the authorities' stabilization policies. A continuation of this effort will still be needed for some time in the future, and my authorities have already indicated their intention to seek a new stand-by arrangement at the expiration of the current one. A Fund mission is to leave for Honduras shortly after the Board's Article IV discussion, to start talks with the authorities regarding this new arrangement. The authorities are in broad agreement with the comprehensive set of papers prepared by the staff for the Article IV consultation, and, in their view, these documents will serve well as a basis for the definition of economic policy under a new arrangement with the Fund.

The Central American countries have been individually discussed by the Board on several occasions during the past three years, not only in the context of Article IV consultations but also in regard to requests for the use of Fund resources. In practically all these discussions, this chair has mentioned that in order to understand the recent evolution of these economies, Directors must view them in the broader perspective of international and regional developments and the effects that they have had on the small, relatively open and vulnerable economies of the Central American countries. Honduras has, of course, not escaped these shocks, and external factors have played an essential role in determining recent economic developments. In Honduras, closer regional and domestic social and political factors have further aggravated the climate of confidence, and economic activity has declined substantially. It should be added that a speedy recovery of economic activity in the near future cannot be realistically expected, and the staff is quite correct in adopting a much more cautious stance in evaluating such prospects, especially because of their implications for the design of stabilization policies. Since in previous statements on Central American countries I have already touched in some detail on these external factors and their effect on the regional economies, I will refrain from further elaboration on the same topic. I would only add that those factors will continue to exert adverse pressures on these economies for some time in the future. Thus, the formulation of economic policy for countries in the Central American region should take these facts well into account and adapt a strategy that would serve to minimize the adverse effects while setting the basis for financial stability. In this regard, there is clearly a need for imaginative and innovative policies that would further internal and external redressment without redimensioning these economies to intolerably reduced levels.

Performance under the current stand-by arrangement has admittedly been mixed, as initial significant departures from the program have also been significantly reduced through a variety of compensatory measures. As seen in Table 1 of the staff report, in the current year Honduras has complied with all performance criteria except that regarding net credit of the banking system to the public sector. The staff has explained at some length the causes for these deviations--which have centered in the fiscal area--and there is no need to repeat them. I would add, however, that this performance--under the circumstances of Honduras--is much better than would at first appear, and shows the authorities' determination to maintain financial discipline. Maybe more importantly, and even independently of the narrow measure of numerical compliance, the program has served well in furthering such discipline and in avoiding the even further deterioration that could have been expected given the surge of unforeseen adverse developments in the region in general, and in Honduras in particular. As I have stated on previous occasions, the formulation of economic policy in Central America is indeed a difficult exercise in current circumstances.

Given these circumstances and the problems experienced by Honduras in the implementation of the current stand-by program, it is quite evident that issues related to short-run stabilization policies should be of primary importance. Indeed, it is somewhat doubtful if longer-term issues could be reasonably addressed with some degree of assurance, although they should obviously be borne in mind in framing economic policy. The authorities and the staff have correctly recognized this and have centered the consultation discussion primarily on issues related to short-run stabilization policy. In this regard, the authorities would be in general agreement with the staff regarding the main issues and will express more detailed opinions regarding specific areas of policy during the forthcoming discussions with the Fund mission. I will also refrain from extensive comments in this regard, and will only make a few concise remarks.

As regards fiscal policy, there would seem to be no doubt that there is need for further adjustment in this area. In this connection, revenue collection could be improved and the tax burden increased, although I would caution on the speed with which such adjustment can be carried out. In great part, the problems related to the fiscal area are of a structural nature, and rapid changes cannot realistically be expected. A strong shift toward increased revenues on domestic activities--as opposed to trade-related revenues--is necessary, but it takes some time to accomplish.

Monetary policy must play a complementary role to the fiscal adjustment and should be compatible with the external objective. The authorities are well aware of this and have traditionally followed prudent and even restrictive policies. The excess liquidity in the system may represent a threat to monetary stability, and the authorities are considering different possibilities of sterilizing part of it, but care should be taken not to hamper the process of bringing banks into compliance with legal reserve requirements. The choice of instruments to bring about a tightening of monetary policy should take these considerations into account.

As regards interest rates, the present maximum levels would seem to be high enough to allow for a flexible policy, given the current inflation rate. However, the authorities stand ready to review these rates if warranted.

On several previous occasions I have indicated our views regarding exchange rate policy in Central America. It is difficult to think that an equilibrium rate can be established with a certain degree of precision under circumstances of severe uncertainty, or that there would be a significant response of exports and positive capital inflows in the short term, as a consequence of exchange rate adjustments. The negative costs associated with such adjustment might outweigh the possible short-run benefits. This should not be interpreted as saying that exchange rate policy should be completely disregarded. For the medium term, real exchange rates should be such as to promote exports and efficient resource allocation; and competitiveness of exports should be safeguarded permanently. But we should not overrely on exchange rate policy for adjustment, overburdening it sometimes with multiple objectives and too-rapidly expected results in the shorter run. A precise analysis of costs and benefits is needed, with the precise inputs of the specific country in question. The Honduran authorities would want this issue to be approached with such an open mind.

Mr. Robalino observed that Honduras had fulfilled most of the quantitative performance criteria up to September, the only exception being in the central government finances. The ceiling on net credit of the banking system to the public sector had been exceeded by 8.3 percent, in good part because public revenue had been weaker than projected. That weakness stemmed largely from the high proportion of public revenue--45 percent in 1981--derived from international trade, which was unstable and was expected to fall by 15 percent compared with the original estimate for 1983. Moreover, despite several revenue measures introduced in 1983, there had been no improvements in the performance of the tax system, because--as Mr. Senior had noted--the problems were mostly of a structural nature.

The determination of the Honduran authorities to reduce domestic and external imbalances, in spite of all the difficulties, could best be seen in the behavior of the current account, which would be in better shape in 1983 than originally estimated, Mr. Robalino commented. Although exports had not grown as planned, the authorities had been able to obtain an improvement in the balance of payments through a sharp adjustment in imports.

Monetary policy had been tight in 1983, Mr. Robalino noted, and the authorities had encouraged both the growth of financial savings and a better allocation of resources. The present maximum interest rate level was high enough to permit a flexible policy and the authorities should be commended for not changing the prevailing high ceiling in the present year.

He commended Honduras for its relatively free trade system, Mr. Robalino continued. As for exchange rate policy, he did not think it advisable for the authorities to risk domestic price stability and the destabilizing effects on wages at a time when they were willing to follow an adjustment program based primarily on demand policies.

Mr. Clark considered that the staff report revealed some rather worrying developments. First, the Honduran economy had clearly deteriorated significantly from an already bad position in 1982. Second, because of inadequate policy responses to the deterioration, the 14-month stand-by arrangement approved in November 1982 had drifted seriously off course. Third, despite having breached performance criteria continuously since the approval of the program, Honduras had nevertheless continued to draw 80 percent of the amount available under the stand-by, apparently owing to a misclassification of banking credit to the public sector. Although the breach should surely be regarded as an important feature of performance under the program, it was in fact only mentioned in a footnote to Table 1 in SM/83/224. He recognized the difficulties, particularly the security problems, with which the authorities in Honduras had had to contend, but he would like to learn more from the staff about the circumstances in which the breakdown of the program had gone undetected for so long.

For the future, Mr. Clark added, he would stress the need to bring the fiscal position under control. What had passed for adjustment so far had depended very much on import restrictions rather than on an improvement in the balance of the domestic economy. All in all, should a new program be contemplated in due course, it might be helpful to make provision for a mid-term review of progress.

Mr. Erb said that the staff report provided an accurate picture of the difficult economic and financial situation in Honduras. He was in broad agreement with the staff appraisal and concurred with the staff's policy recommendations. The impression left by the report was that the full implications of the wide-reaching and serious problems facing Honduras were only now becoming fully appreciated by the Government. In that regard, he welcomed the candid statement in the first paragraph on page 10 of SM/83/224 about the more cautious approach by the authorities and the staff to the prospects for economic recovery, which should provide an appropriate basis for framing the type of adjustment effort that was clearly required at present. He agreed with Mr. Clark that part of that effort should be a much more significant fiscal adjustment.

As the staff and authorities worked to formulate a follow-on adjustment effort, perhaps to be supported by Fund resources, Honduras's record of poor performance under its past two arrangements with the Fund had to be borne in mind, Mr. Erb stated. The more general question was thus raised of how the staff planned to approach the discussion of a future program with the Honduran authorities, and whether possibly it might take the form of drawing up a shadow program that would last for a while, and under which significant action would be taken, prior to the staff's bringing the program to the Excutive Board for approval.

On a final point, Mr. Erb said that like Mr. Clark he was disturbed to learn that revised data on net credit of the banking system to the public sector showed that Honduras was not in compliance with the relevant performance criterion. He would welcome reassurance from the staff that appropriate procedures were in place to prevent a recurrence of that situation.

Mr. Shaw remarked that the Honduran authorities obviously faced a formidable task. When the Executive Board had approved the present stand-by arrangement in November 1982, many Directors, including his chair, had noted that the adjustment called for in the program might have been too gradual. There had been skepticism about the forecast improvement in the current account position for 1983, particularly in light of the failure of the program under the extended Fund arrangement in 1982. Directors had thus urged the authorities to implement more restrictive demand management policies and to adopt a more competitive exchange rate policy.

The stand-by arrangement approved in late 1982 had had mixed results, Mr. Shaw went on. While it was true that Honduras had complied with all the performance criteria, with the exception of the ceiling on net credit by the banking system to the public sector, it should be remembered that that criterion had been designed to monitor the fiscal targets, and that it was the fiscal imbalance that was to have been the main focus of the adjustment program. Moreover, a further cause for concern was that the original data provided by the authorities, as Mr. Erb had mentioned, had indicated that the program was on track, which in the event had proved not to be the case. The authorities had made three drawings under the stand-by arrangement, one of which had been delayed, presumably because of difficulties with the data. The effectiveness of the provisions of the stand-by arrangement for monitoring the program could be questioned on that score alone.

In its paper on the review of upper credit tranche arrangements, which had been discussed recently in the Executive Board (EBS/83/215, 10/4/83; EBM/83/155 and EBM/83/156, 11/16/83), the staff had placed great emphasis on the review process, Mr. Shaw recalled. There was perhaps something to be learned from the experience with the inadequate monitoring of Honduras's program. He wondered whether the staff would be able to suggest ways in which to avoid the possibility of failure in monitoring programs in the future. A mid-term review by the Executive Board might have been helpful in highlighting the deviations from Honduras's program at an early stage. The matter should be considered carefully before the Fund proceeded with a new program for Honduras.

Over the past year, Honduras had drawn 121 percent of quota under its stand-by arrangement, Mr. Shaw remarked, yet the fiscal and external imbalances were worse than they had been when the preceding arrangement, under the extended Fund facility, had been approved in June 1979. In essence, the authorities ought to start over again, and attempt to redress those imbalances with the objective of attaining short-term sustainability. The luxury of a gradual approach to adjustment had been overtaken by the events of the past four years.

He agreed with the staff's identification in its appraisal of fiscal correction as being of primary importance, Mr. Shaw said. He urged the authorities to tighten expenditure controls, and in particular to monitor closely budgetary overruns and net lending to the public enterprises. Overreliance on trade-related taxes had led to a situation in which more than 40 percent of government revenue was derived from taxes on foreign trade. He supported the staff view that a shift in the burden of taxation toward domestic transactions was required to strengthen revenue performance. Therefore, a significant reduction in the fiscal deficit would be essential in any new program. At the same time, he recognized that a major proportion of that deficit in 1983 could be financed from foreign sources, so that a smaller reduction than would ordinarily be required might be sufficient.

The other major focus of any new stand-by arrangement would have to be the external sector, Mr. Shaw considered. One aspect of the adjustment would have to be a devaluation. As Chart 8 in the report on recent economic developments demonstrated, the lempira was clearly overvalued. Together with political uncertainty, the overvaluation had contributed to a rather large private capital outflow in 1982 and 1983. Net outflows in 1982 had been $97.9 million, or 3.5 percent of GDP, and were expected to amount to $47 million in 1983. Reliance on debt relief and import restrictions could thus no longer substitute for a more active exchange rate policy. He understood the argument that the long-standing peg to the U.S. dollar had to be maintained in the interest of confidence. But it had become a question of confidence in the viability of the balance of payments over the medium term. The decline in the terms of trade was well established and was unlikely to be reversed in the near future; the recovery in export volume was also unlikely to be strong.

In sum, Mr. Shaw observed, his chair was dismayed at the lack of progress toward adjustment over the past year. Exogenous factors, especially the instability in the region, had played a role, but the authorities might not have been as forceful in implementing a program as they should have been. If there was to be a new stand-by arrangement, it would have to focus on fiscal and exchange rate policy adjustments, and perhaps be accompanied by prior policy action on those fronts.

Mr. Polak recalled that when the Executive Board had approved Honduras's stand-by arrangement for 14 months, no provision had been made for a review. Consequently, the staff report for the Article IV consultation had focused largely on issues related to short-term stabilization policy. It should be remembered that the main object of the program had been to strengthen fiscal performance by means of a combination of revenue and expenditure measures, and to facilitate a sharp reduction in the domestic financing requirements of the public sector, that fiscal adjustment being designed in turn to facilitate the achievement of approximate balance of payments equilibrium in 1983. That twofold objective had not been met. The overall fiscal deficit, which had been targeted to fall to 7 percent of GDP, had remained at about 10-11 percent, the difference having been financed for the most part domestically. The balance of payments deficit had remained the same, but at the cost of severe import restrictions and the distortion of resource allocation. Thus, the program had failed to fulfill its main purpose of returning the economy to a sound financial and economic path.

Because most of the performance criteria had been met, and Honduras had been able to continue to make quarterly purchases for a total of about 120 percent of quota within a year, the question, as other Directors had said, was whether the performance criteria were relevant to the program's objectives and adequate as a test of the implementation of the right measures by the authorities, Mr. Polak stated. For example, in order to limit net borrowing from the Central Bank, which was a performance criterion, the authorities had allowed some internal payments arrears to build up, enabling them to appear to have met the performance criterion. The figures had since been corrected, but nothing had been done about the fiscal objective. Similarly, in the external sector, heavy reliance had been placed on import restrictions, with consequent distortions in the economy.

It seemed to him, Mr. Polak remarked, that Honduras might have been in a better position at present if the performance criteria had shown much earlier that the program was not on track. The Fund and the Government of Honduras could then have discussed what to do in the circumstances. Certainly, if there was any suggestion of considering a new stand-by arrangement for Honduras, a great deal of thought should be given to the selection of appropriate criteria so as to ensure use of the Fund's resources that would move the economy toward the objectives sought.

The staff representative from the Western Hemisphere Department said that when the program had been brought before the Executive Board in November 1982, the staff had been reasonably confident that it would move forward successfully. A number of prior actions had been taken in the fiscal area, according to plan, and the only other measure that in retrospect should perhaps have been stipulated as a prior action was the actual bringing into force of the customs tariff reform. It had been expected that the reform would pass once it was before the Legislative Assembly and had the support of the Executive branch of the Government; instead it had fallen victim to the political process and to an internal dispute on the technical and economic effects of the proposed new tariff.

As for the monitoring of the program, the staff representative explained that the staff had observed, early in 1983, that a deviation had developed in December 1982; it made the first of three visits to Honduras that were designed precisely to engage in special consultations to look into ways of keeping the program on track. The first visit had been required in part because the staff wanted to correct certain problems in the organization of data, one of which had re-emerged on the third visit. The large deviation that had been discerned was in the limit on credit to the nonfinancial public sector. The staff and the authorities had reached the judgment that it might still be worthwhile at that time in the year to take measures to correct the deviation, and stay within the program. As a matter of fact, in terms of credit flows rather than of credit stocks, the Government had made much less incremental use of credit from the Central Bank in 1983 than in 1982. However, the large deficit at the end of 1982 in the stock magnitude set for the program meant that even though the authorities had been living within the flow limits set for the current year, they had still had a problem in bringing credit below the program limits.

As a result of the staff's first visit, the staff representative continued, it had been agreed, first, that procedures for the collection of taxes on incomes were to be strengthened. Second, further cuts in the budget were to be made in order to bring expenditures into line. Third, there was to be more intense work on reducing the burden of public sector entities on the Central Government because of the inability to make foreign debt service payments. In the event, the actions taken had had less impact than had been intended or needed.

The second staff visit, which had taken place in June 1983, had been called for in the letter of intent, the staff representative noted. It was a consultation with the staff, not a mid-term review by the Fund, and had focused primarily on the problem of import restrictions. The intention had been to see whether the performance under the program would provide a basis for liberalizing the restrictions. The authorities had stated that under the circumstances at that time, they needed to maintain them. However, the change in the import licensing system recently announced could be understood perhaps as the first step in the liberalization of the restrictions, or even as a move toward considering a parallel market. The staff would take up that aspect in further consultations with the authorities.

The third staff mission had been for the purpose of the Article IV consultation, the staff representative remarked. It was the occasion on which the staff had found that, even though some corrective policy actions had been taken to reduce the deviations that had developed under the program during the year, their impact had been less marked than had been expected. Problems had also arisen relating to the treatment of certain government operations, some of which were considered of a highly sensitive nature, such as those affecting the financing of certain defense expenditures that had not been part of the budget in 1983 but had been additional expenditures assumed during the year because of the general situation in Central America.

As for any future program, the staff representative from the Western Hemisphere Department concluded, a strengthening of the review process would have the wholehearted support of the staff. A formal mid-term review with the Fund should be built into any future stand-by arrangement. Furthermore, as mentioned by several Executive Directors, it would be necessary to seek as many prior actions as possible in the fiscal area to offer the greatest possible assurance that any future program would have a better chance of success than the one that was coming to an end. Only when the staff was convinced of the possibility of success would it bring a program forward for consideration by the Executive Board.

The staff representative from the Exchange and Trade Relations Department said that it was quite an uncommon experience for a member to have made drawings under a stand-by arrangement when the performance criteria had not been met. It was important to prevent the observance of performance criteria from being undermined in that fashion, and the staff had been examining possible ways to handle, ex post, cases like the present one in which purchases had been made while the economy's performance, as measured by the program criteria, had not been on track. Procedures did not exist at present because no need for them had arisen until now.

The two issues for consideration, the staff representative added, were, first, the possibility that the criteria did not accurately trace the performance of the economy itself because they could not be formulated on a sufficiently precise data base and could, therefore, be subject to revision at a later date. The revisions could be significant and reveal serious departures from the program. That possibility led into the second issue, which had both policy and legal implications, concerning the best procedure for dealing with drawings found to have been unjustified because of nonobservance of performance criteria. A concept similar to the one underlying the Fund's policy on early repurchase could perhaps be applied. The matter would be discussed by the staff, in consultation with the Legal Department, and a paper examining possible options on the subject could be prepared for consideration by the Executive Board.

Mr. Senior said that developments in the Honduran economy and the country's performance under the stand-by arrangement with the Fund had properly to be analyzed in the broader context of world developments and the precise circumstances of the Central American region. In that context, he would not hesitate to reiterate his opinion that although the numerical results had admittedly been mixed, Honduras's performance under the stand-by arrangement had been satisfactory in the circumstances. After significant departures from the program targets and limits, a strong effort had been made by the authorities to narrow the deviations and get the program back on track. The outcome, if not wholly successful, had at least represented a significant improvement, which had underscored the authorities' determination to restore financial discipline. In that sense, the program had served Honduras well, a point that should be borne in mind in analyzing its effectiveness and in formulating a new program.

Second, Mr. Senior went on, he would stress once again the particular difficulties of framing economic policy in the current situation in Central America, and in Honduras in particular. It was clear that social and political instability--domestic and regional--was of such a magnitude that it had greatly hampered private domestic and foreign investment, but it had not reached such proportions that the country was living with a virtual war economy. Thus, the authorities were confronted with a mixed panorama in which traditional, orthodox policy instruments still had to be applied, as if circumstances were normal, but with obviously limited results. A more significant departure from those instruments would probably have even more adverse consequences. Therefore, there was little scope for policy formulation; the authorities were in a way forced to frame a strategy that would minimize the deterioration of economic activity so as to prevent the emergence of major disequilibria that would hinder the attainment of sustained growth in the future, when the region eventually returned to more normal conditions. At the same time, the need for a medium-term strategy could not be completely disregarded, especially in a country where future growth would depend greatly on a rather limited number of relatively major current investment projects.

Consequently, Mr. Senior concluded, even while greater emphasis had to be placed on short-run policy adjustments, they should be framed in the context of a medium-term analysis, tenuous as that analysis might be in present circumstances. Reconciling those two basic needs was not an easy task for the Honduran authorities, and they would surely be greatly assisted by the staff's expertise in the forthcoming negotiations for a new arrangement.

The Chairman made the following summing up:

> Executive Directors were in general agreement with the thrust of the appraisal contained in the staff report for the 1983 Article IV consultation with Honduras. Directors expressed disappointment with the results achieved to date in the context of the present stand-by arrangement. The failure to achieve the program's fiscal objectives was partly the result of the weak state of the economy, but mainly of serious slippages in the implementation of the fiscal program. Honduras's track record in its financial programs with the Fund needed to improve greatly, Directors emphasized, and they expressed particular concern about Honduras's failure to observe the ceiling on credit to the nonfinancial public sector.
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> Directors emphasized that a strengthening of the fiscal performance was essential for the achievement of the Government's stabilization objectives. They stressed the need to ensure that expenditures be kept in line with the availability of financing and emphasized the importance of shifting the burden of taxation toward domestic transactions. The importance of accurate and timely data on fiscal operations was also stressed.

Directors encouraged the Honduran authorities to phase out import restrictions since these gave rise to distortions in resource allocation, which undermined the prospects for a sound economic recovery. They emphasized that import restrictions and other payments restrictions should be replaced with more flexible management of the exchange rate, which would help to foster the improvement in export performance required to service the external debt in coming years.

In considering possible further financial programs with Honduras, great care will have to be exercised, Directors said, to avoid the possibility of any slippages such as had occurred, and they called for close periodic reviews of possible further programs.

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

APPROVED: March 27, 1984

LEO VAN HOUTVEN
Secretary