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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/5

10:00 a.m., January 11, 1991

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	B. R. Fuleihan, Temporary
	L. E. N. Fernando
	G. C. Noonan
	Zhang Z.
T. C. Dawson	J. M. Abbott, Temporary
	S. B. Creane, Temporary
	M. E. Hansen, Temporary
	J. Prader
E. A. Evans	G. H. Spencer
	B. Bossone, Temporary
M. Finaish	
M. Fogelholm	
B. Goos	H.-J. Scheid, Temporary
J. E. Ismael	
A. Kafka	
	J.-L. Menda, Temporary
	G. Serre, Temporary
	O. Kabbaj
L. B. Monyake	L. J. Mwananshiku
	P. Wright
G. A. Posthumus	G. P. J. Hogeweg
	D. Saha, Temporary
	G. Montiel, Temporary
A. Végh	A. G. Zoccali
	N. Tabata
	K. Ichikawa, Temporary
	K. Ishikura, Temporary

L. Van Houtven, Secretary and Counsellor
M. J. Miller, Assistant

Also Present

IBRD: S. Ijichi, P. Hamidian-Rad, Africa Regional Office; L. R. Kenward, Asia Regional Office. African Department: E. L. Bornemann, Deputy Director; E. A. Calamitsis, Deputy Director; P. Dhonte, H. Hino, I. Kapur, P. H. Mathieu. Asian Department: C. M. Browne, M. J. Fetherston, R. Kibria, R. Sahay, J. Schulz. European Department: U. Dell'Anno, M. Huybrechts, K.-W. Riechel, H. Vittas. Exchange and Trade Relations Department: T. Leddy, Deputy Director; G. Bélanger, Y. J. Cho, M. E. Edo, S. Kanesa-Thasan, G. R. Kincaid. Legal Department: H. Elizalde, P. L. Francotte, R. B. Leckow. Middle Eastern Department: F. Drees. Treasurer's Department: G. Laske, Treasurer; D. Williams, Deputy Treasurer; M. P. Blackwell, J. E. Blalock, W. J. Byrne, W. L. Coats, Jr., Z. Farhadian-Lorie, P. Fontana, G. Wittich. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: J. O. Aderibigbe, M. A. Ahmed, C. D. Cuong, J. M. Jones, F. A. Quirós, A. Raza, B. Szombati. Assistants to Executive Directors: B. Abdullah, T. S. Allouba, G. Bindley-Taylor, S. K. Fayyad, A. Fanna, M. A. Ghavam, L. I. Jácome, M. E. F. Jones, P. Kapetanovic, W. Laux, G. Lindsay-Nanton, M. Mrakovcic, L. Rodríguez, S. Rouai, D. Sparkes, N. Sulaiman, C. M. Towe, Wang J., Tin Win.

1. ALBANIA - MEMBERSHIP - EXPRESSION OF INTEREST

The Chairman informed Executive Directors of an expression of interest in membership on the part of Albania.

2. SIERRA LEONE - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered a staff paper on the further review of Sierra Leone's overdue financial obligations following the declaration of its ineligibility to use the Fund's general resources effective April 25, 1988 (EBS/91/1, 1/4/91).

The staff representative from the Treasurer's Department stated that since the issuance of the staff paper, Sierra Leone had made additional payments to the Fund of $1.5 million, equivalent to approximately SDR 1.1 million. Therefore, since the previous review on August 10, 1990, Sierra Leone had paid the Fund SDR 1.67 million toward obligations that had fallen due during that period of almost SDR 8 million, or 21 percent of its new obligations. Additional payments were expected from Sierra Leone in the succeeding period. In the staff's view, those payments should be in amounts consistent with the objective of stabilizing the level of Sierra Leone's arrears to the Fund pending agreement on a rights accumulation program. The staff intended to communicate that view to the authorities before a mission was sent to discuss a rights accumulation program for Sierra Leone.

Mr. Mwananshiku made the following statement:

> The Sierra Leonean authorities are grateful to the Board for acceding to their request for a postponement of the discussion on Sierra Leone's overdue obligations to the Fund. They have used the intervening period to strengthen their adjustment efforts and to mobilize some resources for further payments. Directors will note that a sum of $400,000 was paid on December 28, 1990. A further payment of $1.5 million was made recently, as stated by the staff. The singular message that the authorities wish to convey is that they remain committed to continuing their cooperation with the Fund not only to solve the problem of arrears, but also to develop appropriate policies that would create opportunities for sustained economic growth in a stable macroeconomic environment.
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> With the assistance of the staff, some progress has been made in addressing some of Sierra Leone's economic problems. In particular, a policy framework paper has been prepared, and the authorities have committed themselves to doing what is necessary to establish a basis for a Fund-monitored program to take advantage of the intensified collaborative strategy to help

countries with protracted overdue obligations to the Fund. The staff mission to Sierra Leone in November 1990 and the subsequent visit by the authorities to Washington in December 1990 have led to further understandings as to how the adjustment effort might be strengthened.

Particular attention is being given to improving fiscal performance during the second half of the fiscal year, that is, from January through June 1991. To this end, the Ministry of Finance has put in place a new system of expenditure control whereby spending commitments in any month are limited to available resources. Moreover, a proposal to restructure the Ministry of Finance to enhance its effectiveness is under consideration by the Establishment Minister. Meanwhile, an increase in revenue is projected, predicated on, among other things, the signing of a fisheries agreement with the European Community and the implementation of a new diamond policy. A communication received from the authorities just a few days ago confirms that they intend to sign the fisheries agreement shortly, and that the diamond marketing policy will become effective on January 15, 1991. For the fiscal year as a whole, the supplementary budget submitted to parliament on December 11, 1990 projects an increase of 3.6 percentage points in revenue relative to GDP in 1990/91 compared with the previous year, while expenditure as a percent of GDP will remain broadly unchanged. The overall budget deficit is expected to drop by about 3 percentage points relative to GDP in 1990/91 compared with 1989/90.

On the monetary front, the authorities intend to contain the growth in liquidity of the banking system. In this regard, in September 1990, Le 0.5 billion of treasury bills held by commercial banks was excluded for the purpose of meeting the reserve and liquidity requirements. An additional Le 0.3 billion was warehoused in December 1990. On January 11, 1990--today--another Le 300 million of treasury bills held by commercial banks will be warehoused.

As a further indication of their commitment to the adjustment process, the authorities have established a Structural Adjustment Steering Committee, including the Minister of Finance as Chairman, and other economic ministers and senior officials.

Although the recent payment of $1.5 million is small in relation to Sierra Leone's total arrears to the Fund, it is quite significant in terms of the foreign exchange available to Sierra Leone. The staff paper notes that at the end of November 1990 the Bank of Sierra Leone had only about $100,000 of usable foreign exchange reserves. Moreover, in making external debt-service payments, Sierra Leone has accorded priority to the Fund. Between

January and September 1990, out of a total payment of SDR 7 million, the Fund received SDR 5.9 million.

Mr. Ichikawa made the following statement:

It is unfortunate that the implementation of the original adjustment package has met with considerable difficulties due to the influx of Liberian refugees and the oil price increases associated with the Middle East crisis. Sierra Leone's disappointing performance during the latter half of 1990 is also a result of the fragile macroeconomic framework of the program, as well as the country's limited administrative capacity. Against this background, we welcome the fact that the authorities have implemented wide-ranging corrective measures, with technical support from a Fund mission, in order to prevent a further deterioration of the economy. We strongly hope that the authorities will demonstrate a fair track record under the comprehensive program and the supplementary measures.

We appreciate the staff's report this morning that the Fund received another SDR 1.1 million from Sierra Leone. Nevertheless, the amount has fallen far short of current obligations since August 1990. Again, we urge the authorities to initiate, as a matter of urgency, meaningful regular repayments to the Fund.

We have a general concern on the issue of Sierra Leone's prospects for embarking on a rights accumulation program. First, one of the most important conditions of the rights program is that the country should remain current throughout the period. We are concerned about the poor repayment record of Sierra Leone to date. We are not sure, either, about whether or not the new diamond exports policy can really strengthen the authorities' repayment capacity effectively. The authorities need to demonstrate their willingness and ability to make current repayments. Second, because of the initial delay in establishing a track record, the Board will have too short a period in which to review the country's prior actions, if it is to approve the rights accumulation program before the next Interim Committee meeting. Third, also due to the delay in Sierra Leone's initiation of corrective measures, a financial arrangement sufficient to support the rights program is not yet in place. The Board will not be able to approve a rights accumulation program without sufficient financial assurances.

All in all, the concerns I have just mentioned point to the need for a closer and more frequent review of Sierra Leone's overdues situation. While there may be some technical difficulties with policy review, we consider that the Board could review at least the country's repayment situation by mid-April 1991. My authorities consider that the next review should be conducted within three, rather than four, months, as they hope that the next review by mid-April will provide the Board with a better perspective on the question of the rights approach, or any other possible approach. We do not have any difficulty with the other part of the decision.

Mr. Wright made the following statement:

Since this review was postponed one month ago, the authorities have introduced a supplementary budget to address the fiscal slippages that had re-emerged. There are also signs that, at long last, the authorities have taken the first steps toward harnessing the country's fisheries and mining resources in ways that should benefit the revenue and foreign exchange position, although it is disappointing that the introduction of the proposed tax on diamond traders has been postponed once again. Nonetheless, I believe that if these measures are implemented vigorously and built upon--and this has not in the past been the authorities' strong point--they could mark a turning point in Sierra Leone's fortunes.

Meanwhile, Sierra Leone's payments record has been mixed. The authorities deserve credit for the considerable efforts they have made in recent weeks to make payments to the Fund. But the Board cannot ignore that, over the period as a whole since the August review, Sierra Leone has met only 21 percent of its obligations falling due, a deterioration compared with the previous 12 months, although a small improvement on the payments received between the April and August reviews.

The Board has already shown exceptional forbearance in the matter of Sierra Leone's arrears to the Fund. Today's discussion is the seventh post-ineligibility review, and it is now over two and one-half years since a declaration of ineligibility was issued. Since then, despite the continued buildup of arrears, no further remedial measures have been taken, and the staff has been tireless in its efforts to help Sierra Leone find a solution to its economic problems.

Although there remains some question as to the extent to which Sierra Leone is cooperating with the Fund, I believe that in the present circumstances further remedial measures would only undermine the position of those in Sierra Leone who are trying to keep the momentum of reform going. Our refusal to endorse a rights accumulation program--with the additional donor support that it would trigger--until Sierra Leone establishes an adequate track record is still the most effective sanction which the Board has.

But, if remedial measures are to be postponed once again, the question is how best we can convey to the authorities that the Board's patience is not inexhaustible, and at the same time lay the groundwork for a possible rights accumulation program in the future.

I can agree with Mr. Ichikawa that this might best be done by shortening the next review period from four months to three months, and sending the authorities a clear signal that, over the next three months, there must certainly be no further increase--and preferably a reduction--in their arrears, and that this must be achieved by making regular, rather than last-minute, payments to the Fund. With respect to policy cooperation, the Board will need to be convinced at the next review that expenditure has been kept under tight control, and that the authorities have done all they can to ensure that the mining and fisheries sectors are contributing fully to the country's revenue and foreign exchange position.

This will be a severe test of the authorities' commitment, and they will have to strengthen their resolve substantially. But the establishment of a sustained track record of both policy and payments cooperation is essential before there can be any question of a rights accumulation program.

I would suggest that the time has come for the Managing Director to communicate directly to the President of Sierra Leone the Board's expectations, and remind him of the very limited amount of time that remains available if Sierra Leone is to embark on a rights accumulation program. It remains my belief that such a program is within Sierra Leone's grasp, and I urge the authorities not to squander what may be their final opportunity.

Mr. Noonan made the following statement:

Sierra Leone has undoubtedly been subject to a number of adverse external shocks in recent months, and the staff paper provides grounds for cautious optimism regarding the authorities' intention to set the economy back on track toward external and internal balance. However, there are a number of reasons for questioning both their commitment and ability to achieve this objective.

First, notwithstanding the effects of the influx of refugees and the Middle East crisis, Sierra Leone has yet to demonstrate its ability to sustain an adjustment program. Indeed, despite the strong economic and financial policy framework paper of last July, economic performance in the first six months of fiscal 1990/91 was disappointing.

Second, despite the Board's repeated stress on the importance of remaining current, Sierra Leone's arrears to the Fund have grown since the Board's last review. While the authorities' recent payment is encouraging, it would appear that payments to the Fund in the current fiscal year are well down on the inadequate level of 1989/90.

Third, as both Mr. Mwananshiku today, and Mr. Monyake in the past, have made clear, the issue of the availability of foreign exchange remains crucial. Especially critical is the ability of the authorities to channel foreign exchange earnings into official channels. Sierra Leone is a country richly endowed with gold and diamonds. These resources are being exploited and the proceeds, including foreign exchange, are accruing to some people. The staff paper and the policy framework paper of last year acknowledge that the new foreign exchange market is unlikely to function properly unless diamond exports are brought into official channels. Moreover, while the recent supplementary budget contained a number of encouraging revenue measures, an effective adjustment to the fiscal balance also depends on the authorities' ability to bring the earnings of the diamond sector into official channels. In this regard, we recall that the operations of the new exchange system were to be reviewed in November 1990, in consultation with Fund staff, with a view to strengthening the effectiveness of the system and abolishing remaining restrictions, as appropriate. Mr. Mwananshiku has informed us that the new diamond export policy comes into force on the 15th of this month. I wonder if the staff could elaborate on the findings of its review, and the prospects for the success of the new policy.

Fourth, we have some reservations regarding the quality and effectiveness of the recently announced revenue measures. For instance, the projections for the latter half of the fiscal year seem to indicate that sales tax revenue will continue to be well below the original budget projection. Revenue from this source must be increased, and we believe that there is scope for doing so. In addition, we would be concerned about the possibility of the authorities reinstating the discretionary import duty exemptions, which appear to have been suspended only until end-June 1991.

Developments on the monetary front also illustrate the pernicious effect of the fiscal deficit. While we applaud attempts to reduce the central bank's financing of the deficit, it would appear that this source of financing has been supplanted, at least in part, by the introduction of warehousing of treasury bills. This measure--which implicitly increases commercial banks' liquidity requirement above the already high statutory 55 percent level--provides the authorities with a convenient captive commercial bank market for government paper. However, this, and the extremely high real rate on government paper--roughly 17-27 percent--will crowd out private sector investment, and severely limit Sierra Leone's growth potential.

Finally, I note that the staff paper suggests that a necessary condition for a rights accumulation program would be the satisfaction of the financial benchmarks to end-March 1991, rather than the benchmarks to end-June, which would coincide with the end of the fiscal year. While I am mindful that access to a rights accumulation program will lapse on April 29, 1991, I am concerned, like Mr. Ichikawa and Mr. Wright, that the authorities would not have been able to establish a track record regarding their ability to adhere to program targets by this date. Moreover, I recall from our December 5 discussion that the staff seemed to have serious reservations regarding the authorities' ability to provide the data necessary to monitor a program. Would reliable data for end-March be even available by that time? I wonder whether the staff could comment.

Mr. Goos stated that he recognized that Sierra Leone found itself in a very difficult situation, which was partly due to the oil price increases and the situation in Liberia. Those adverse developments certainly offered no excuse for the previous delays in the adoption of appropriate adjustment measures, however. The severe shortages of oil products and domestic power supply and the concomitant interruptions in production seemed to indicate that the economy was headed toward disintegration.

Against that background, he welcomed the encouraging policy decisions that had recently been announced, and hoped that the authorities would demonstrate their determination and ability to strictly adhere to the policy targets, Mr. Goos continued. That would be absolutely essential not only for a turnaround in the economic situation, but also for the credibility of the authorities' adjustment strategy, and--as had been stressed by previous speakers--the ability of the Fund to assist the country in the context of a rights accumulation program. A renewed failure to stay the course would leave the Board with no alternative but to move further ahead in the application of the Fund's arrears strategy.

The recent payments to the Fund were certainly welcome, Mr. Goos commented, but, like previous speakers, he had noted that even considering those payments, Sierra Leone's arrears to the Fund had continued to accumulate. It was most regrettable that the authorities had failed so far to commit themselves at least to staying current in their overdue obligations to the Fund as they fell due starting from the level of arrears of November 1990, as the staff had proposed. At any rate, such a commitment would be a precondition for the conclusion of a rights accumulation program.

Against that less than satisfactory background, he could go along with the thrust of the proposed decision, although, for the reason mentioned by Mr. Ichikawa, he believed that the period until the next review might be shortened to three months, Mr. Goos observed. Moreover, the last paragraph of the decision should be supplemented with the standard clause that the Board might have to consider further remedial action if the authorities continued to fail to resume active cooperation with the Fund. Alternatively, he could go along with Mr. Wright's proposal that such a clause be included in the Managing Director's letter to the authorities, or to the President, reporting on the current Board meeting.

He would appreciate it if the staff could elaborate on the causes of the substantial fluctuations in exchange rates and prices that had occurred in the previous year, Mr. Goos concluded. He also understood that it had been a deliberate decision of the authorities to accumulate arrears to domestic suppliers until the middle of 1991. Although such a decision might protect the Government's fiscal and monetary targets, he was very concerned about its negative effects on the business climate and private sector confidence, which he believed needed to be urgently restored in order to improve the economic situation. He believed that the authorities should adopt without delay additional fiscal adjustment measures in order to create the room for prompt noninflationary payments to domestic suppliers and the elimination of the remaining arrears.

Mr. Serre made the following statement:

> During the Board's last review of Sierra Leone's overdue financial obligations to the Fund in August 1990, this chair welcomed the new policy stance adopted by the authorities in seeking to lay the foundations for a Fund-monitored program under the intensified collaborative approach. We regret that slippages in the implementation of policy during the third quarter of 1990, as well as exogenous factors, have hindered the conclusion of such a program as originally scheduled. I will make some remarks on the current situation with respect to the two criteria for judging the extent to which a country is cooperating with the Fund.
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> First, regarding the appropriateness of economic and financial policies, it is clear that the deterioration of the economic situation during the second half of 1990 should be reversed in a comprehensive and vigorous manner during the coming months, in order to obtain a sufficient track record consistent with the guidelines of the Fund. We would thus like to insist on the urgency of clarifying the situation vis-à-vis the diamond

sector, in order to raise the additional foreign exchange necessary to meet the balance of payments needs. We also urge the authorities to implement vigorously the policy package in the supplementary budget adopted last December, in order to give a clear signal to the international financial community of the authorities' willingness to move ahead in that regard. Eschewing further government borrowing from the central bank will be of a paramount importance in that connection. Finally, I would appreciate some comments from the staff on the difficulties that the authorities encountered in implementing the domestic sales tax.

Second, concerning the country's payments performance to the Fund, despite the staff's latest information, we can only express some disappointment on the modest amount that has been paid. It is important that those payments be increased and that they be made on a regular basis.

With those considerations in mind, we can support a revised draft decision reducing to three months the period until the next review. A three-month period is consistent with the deadline of end-March 1991 established by the staff to assess the progress made in both policy and payments performance. At the end of this period, we would be able to assess the feasibility for the authorities to embark resolutely on a comprehensive rights accumulation program.

Mr. Evans made the following statement:

The review of Sierra Leone's overdues last August took place against the background of promises of a move toward economic stability in the first half of 1990, and was accompanied by Board discussion of a policy framework paper setting out the authorities' intentions to adopt and implement a set of macroeconomic and structural adjustment measures to lay the foundation for a Fund-monitored program under the rights approach. At that time, several Directors noted that the intended program represented a substantial adjustment effort by the authorities that would prove difficult, if not impossible, to achieve.

In the event, the positive aura surrounding the last review appears to have been very short lived. A few weeks after the Board discussion, policy slippages and worsening economic and financial conditions forced a staff mission to abandon negotiations on the proposed rights accumulation program and instead to recommend stronger corrective policy measures. The second half of 1990 saw a substantially larger budget deficit, reflecting both lower revenues and significantly higher expenditures, increased recourse by the government to monetary financing of the deficit, and a resurgence in inflation. Since that time, the authorities have been able to do little more than attempt to piece together measures to check the degree of deterioration in the economic situation.

The staff paper reports clearly on the measures that the authorities have, or intend to, put in place, including the most recent--associated with a supplementary budget, and the carrot of as yet unidentified other revenue measures to be taken in 1991, which attempt to limit the effects of the fiscal spending spree to the first half of the 1990/91 fiscal year. The fiscal outcome and inflation rate are now expected to be worse than originally targeted, but still represent an improvement on last year--at least if measured on a commitment rather than a cash basis. The authorities have also decided on--but not yet implemented--a number of structural measures, including authorizing the establishment of foreign exchange bureaus and developing a new diamond export policy.

Although we welcome the measures mentioned in the staff paper, they appear an inadequate response to the situation faced by Sierra Leone. That said, one must take into account certain mitigating circumstances, including an influx of refugees from Liberia and effects of the Middle East crisis, which have complicated the task of the authorities. However, other problems exist, of which the most relevant is the generally limited institutional capacity of the country, including the accounting procedures and practices of the central bank. This area must be speedily addressed--and, hopefully, before a rights accumulation program is agreed upon--as one without the other is unlikely to prove helpful to Sierra Leone.

On the arrears issue, I note that since the time of the last review, new obligations of SDR 8 million have fallen due, of which SDR 0.6 million was paid to the Fund yesterday, and a further SDR 1 million of which is expected to be paid today; I understand that the staff was expecting SDR 2 million. The above suggests that there is little new hope to be found in reviewing the prospects of Sierra Leone settling its arrears. Nonetheless, in view of the authorities' strongly expressed wish to adopt a rights accumulation program as soon as possible, the difficult external situation faced by the country at this time, and the authorities' preparedness to put into place measures to check the deterioration with a fair degree of rapidity, there is little to be gained in taking any decision other than that currently outlined by the staff. As such, I can support the proposed decision.

Expanding on his statement, Mr. Evans commented that there was one issue on which he diverged from the remarks of previous speakers. It was not clear to him that the policies that had been taken to correct the fiscal excesses in the first half of the financial year had been anywhere near adequate. He wished to direct some questions to the staff on that point, drawing their attention to Table 4, which dealt with the budget calculations. The table showed that the deficit for the year would be much the same as that of the previous year--about $7.5-7.75 billion, but that was on a commitment basis. The table showed that when the rundown in domestic arrears was taken into account, the actual cash deficit would increase substantially, and it was, of course, the cash deficit that had to be financed. Was that not the more appropriate basis to be concentrating on, including for the performance benchmarks that had been set up for March and June? He also noticed that there was a benchmark for the ways and means advances. That figure could be met very readily--as could be seen from the table--as the accumulation of foreign arrears was very much a residual item, so any other target within the financing items could be met by running foreign arrears up and down at will. He wondered whether there was a genuine benchmark in that respect. That was rather worrying, and related to Mr. Goos's point as well, that although there was a large rundown in domestic arrears--welcome from one point of view--it was more than financed by an accumulation of foreign arrears. He would like to know what the staff had been saying to the authorities on that point. His main concern was the macroeconomic one, namely, whether or not the same inflationary situation that existed in the first half of the year would exist in the second half, given that on a cash basis there was still a very substantial deficit with very little financing outside of the accumulation of foreign arrears. Related to that, the staff had noted the measure for the second half of the year aimed at limiting expenditure commitments to amounts that were consistent with available financing, which was indeed very sensible. However, the measure needed to be properly defined, because if it were taken at face value, it should seem that there would be no deficit in the current half year, whereas the figures showed that there would be a deficit. What did "available financing" mean? He would have taken it to mean budget revenue. Did it mean any financing, including central bank financing, instead? Similarly, if such a control measure based upon available financing existed, then it should be based on the limitation not of expenditure commitments, but rather of cash expenditures. He hoped that the staff could comment on that.

Mr. Saha made the following statement:

We welcome the efforts being made by the Sierra Leonean authorities to come to grips with their economic and financial difficulties, in order to enable them to normalize their relations with their creditors in general, and with the Fund, in particular. We note that these efforts have been frustrated by adverse exogenous developments, such as the situation in neighboring Liberia and the Middle East crisis, that have placed an undue burden on the central government budget. We also note that as a reflection of the tight budgetary situation, the Government resorted to a large amount of borrowing from the central bank, thereby contributing to the inflationary pressures that were already evident in the economy. We are happy to note that the Sierra Leonean authorities have taken some corrective measures, as elaborated in the staff paper, to deal with the difficult budgetary situation. While we welcome these measures, we would encourage the authorities to strengthen their policies, and ensure their full implementation. In this context, the establishment of a Structural Adjustment Steering Committee is appropriate, and we hope that it will be instrumental in ensuring the attainment of the program objectives and targets. It is also our hope that policy performance, together with regular and adequate payments to the Fund, would encourage the international community to provide the necessary financial assistance under a possible rights accumulation program.

Regarding the overdue financial obligations to the Fund, we welcome the additional payment made today and the authorities' intention to cooperate actively with the Fund on the issue. I support the proposed decision.

Ms. Creane made the following statement:

We are concerned with the performance of Sierra Leone over the period since the last review in August. In looking at arrears cases, this chair has traditionally focused on both policy and payments issues.

Regarding the payments record, we are troubled by the government's inability to mobilize resources until the very last minute. Sierra Leone should have been aware of the need to make substantial payments, or at least sufficient payments, to demonstrate commitment to the resolution of the problem of Fund arrears. This need was even more acute in view of the agreement to postpone this discussion from one month ago.

Sierra Leone's stated intention to start monthly payments to the Fund is commendable. However, it is critical that this intention be translated into a regular pattern of payments. Sierra Leone's past performance gives us pause in this regard, good intentions notwithstanding. We therefore agree with the staff assessment that Sierra Leone's payments performance needs considerable improvement in order to meet the first of the two criteria for cooperation with the Fund.

The other criterion for cooperation--economic performance--has also been disappointing, especially when contrasted with the progress made in the first half of calendar year 1990. We remain concerned about slippages in the areas of government borrowing from the central bank, expenditures and revenues.

While recognizing that Sierra Leone has faced several difficult external shocks--the Liberian civil war and the Middle East crisis--which have strained its resources, there is a perception that the Government as a whole has not been acting as swiftly as possible, or as necessary, to take needed measures. Therefore, although it is encouraging to see that some major corrective policy steps have been taken and planned in order to bring the reform back on track, we urge the authorities to implement these and additional policies rigorously, in order to promote the adjustment process and to protect the Government's credibility. We hope that the establishment of an inter-ministerial Structural Adjustment Steering Committee is evidence of an increased constituency and commitment for reform within the government.

Several of the proposed revenue measures rely on increased taxes in the diamond sector. We understand that the diamond exporters currently owe the government a substantial amount from unpaid mandatory monthly deposits to the central bank. Although recovery of these amounts would go some distance in meeting Sierra Leone's payments to the Fund, the authorities have been unable to collect them, causing us to question whether it is reasonable to expect that additional taxes could be collected. We would also be curious to know whether the increased taxation is likely to affect the Government's efforts to draw diamond exporters into the formal sector, and how much of the slippage in borrowing from the central bank can be attributed to the inability to improve revenues from the diamond sector.

Despite our misgivings about the payments performance and the policy slippages since the last review, we wish to show our support for the efforts now being made to correct structural imbalances and impose financial discipline. We perceive continued reform as Sierra Leone's best means of regaining economic stability and improving its relations with the international community. Therefore, while we have concerns, we support the staff recommendations--with one change. We would suggest that the next review take place after three, rather than four, months.

It is important that the Sierra Leonean authorities understand that they will need to establish a credible track record during this next three-month period in order to avoid consideration of remedial measures at the next review, and that it is to their own economic benefit to take action promptly.

Mr. Fogelholm observed that the staff had said that it was satisfied with the reforms and the measures undertaken by the authorities, and that the measures and targets were appropriate. Like Mr. Evans, he would note that two different concepts were involved--a cash basis, and a commitment basis. Targets on a commitment basis were not the same as targets on a cash basis--of which the latter might be considered more relevant, and more difficult to attain. That being said, he wondered whether the measures that had been taken were really satisfactory and adequate to support the start of a rights accumulation program.

He shared the view of other Directors that the payments record of Sierra Leone had clearly been unsatisfactory, Mr. Fogelholm remarked. Moreover, it appeared from the information in the paper that the country had virtually no reserves. The only way for the Sierra Leonean authorities to serve the Fund in the future would be for them to find a way to incorporate the diamond trade into the real economy and into official channels. That possibility seemed uncertain of attainment for the time being. He would appreciate a comment from the staff or Mr. Mwananshiku on that point.

Sierra Leone was also running out of time to begin a rights accumulation program, as the deadline was April 29, 1991, Mr. Fogelholm concluded. He understood from the staff paper that the staff had discussed with the authorities a possible rights accumulation program for the period October 1990-June 1992. He found that rather puzzling, as it had been his understanding that such a program would have a duration of three years, and the program that had been contemplated for Sierra Leone was clearly not of three years' length. Perhaps the staff could comment on that point as well.

Mr. Posthumus stated that he supported what the four lead speakers had said. It was a pity--at the least--that a country so rich in diamonds could not make better use of the proceeds from them.

The next review, speakers had suggested, would be not in four months, but in three months, Mr. Posthumus commented. At that time, however, he wondered whether the Board would discuss a possible program for Sierra Leone under the Fund's enhanced arrears strategy, or whether there would be a review of the arrears only. That point was not clear in the paper or in the draft decision.

The staff representative from the African Department stated that since the Board was proposing to conduct the next review of Sierra Leone's overdue financial obligations to the Fund in three months' time, rather than four, the staff would propose to consider a rights accumulation program for Sierra Leone after the conclusion of the next review of the overdue financial obligations. That would be necessary to take into consideration Sierra

Leone's performance through end-March 1991 in the assessment of whether or not to begin a rights accumulation program.

The staff had examined closely the working of the foreign exchange market, and had concluded that it was clearly inadequate, the staff representative continued. The authorities intended to introduce foreign exchange bureaus in the near future to encourage more competition among the commercial banks in foreign exchange dealings. The charges of commercial banks in that respect had been very high, and had discouraged market participants from approaching the commercial banks. The decision had been made to reduce the charges, to lower the disincentive to go to commercial banks. Also, a new, quite active bank had entered the country. In that regard, it was to be hoped that more competition would be introduced, and in fact, the commercial banks were currently offering exchange rates close to those in the parallel markets. The commercial banks had been able to sell foreign exchange to the central bank, some of which the bank had used for payments to the Fund, and had also been able to supply a significant--albeit not really very large--amount of foreign exchange for oil imports in the past.

Two large international firms which had operated in the diamond sector in Sierra Leone in the past intended to restart operations in the country, noted the staff representative from the African Department. The authorities hoped that a large portion of the diamond trade would thus be reabsorbed into the official sector. The authorities anticipated that the firms would buy large quantities of diamonds from the smaller independent operators. Moreover, the new foreign exchange bureaus would encourage local independent miners to sell their foreign exchange holdings for local currency, with some of the foreign exchange sold to commercial banks and the central bank. In addition, diamond exporters would be required to convert 20 percent of export proceeds to local currency at the central bank. The staff would be able to ascertain the success of the new foreign exchange arrangements and the effect of the re-entry of the foreign firms into the diamond mining sector in a few months.

Mr. Noonan commented that he understood that, apart from the new firms which were entering the diamond mining industry, the existing diamond exporting sector was comprised largely of expatriates. The policy framework paper had noted that, besides the foreign exchange complications, those currently in diamond mining and trading operations were reluctant to enter into the official channels because of the taxation implications. He therefore wondered whether, assuming those tax implications remained, that particular sector might still be reluctant to bring its earnings into the official channels.

The staff representative from the African Department replied that the problem related to the linking of income taxation to the value of declared exports. Indeed, the staff had found it essential that such a link be broken, and that taxation be based on standard assessments--as had been done in the past--so that there would be no disincentive from the taxation point of view of coming forward to the official sector. Such a system of taxation was to be reintroduced on July 1, 1991. In the interim, income tax would be limited to 0.5 percent of the export value declared. The income taxation system itself would therefore not be a significant deterrent for the return of the foreign firms to diamond mining and trading operations, as well as marketing by the existing expatriate exporters.

The authorities were reviewing all the arrangements regarding waivers of import and other duties, the staff representative pointed out. The authorities had decided to suspend discretionary import duties only for a period of six months because the entire system was to be reviewed by the end of that period, with the intention of retaining only those aspects of the present system which were truly essential. The new system would be in place by July 1991.

The staff would make a recommendation to the Managing Director on the length of any rights accumulation program based on an assessment of the situation in question, the staff representative from the African Department concluded. The performance of Sierra Leone had certainly not been perfect. The staff was emphasizing the need for improved policy performance, and a strong assurance that policy implementation would be sustained, before it could recommend moving forward with a rights accumulation program.

Mr. Mwananshiku stated that he wished to express his gratitude to Executive Directors for their comments on the paper on Sierra Leone, which he would convey faithfully to the Sierra Leonean authorities.

Directors had suggested that the period until the next review of Sierra Leone's overdue financial obligations to the Fund be reduced from four months to three, Mr. Mwananshiku recalled. It might be better to retain the period of four months, so that the review of overdues could be considered simultaneously with a possible rights accumulation program, provided that Sierra Leone could show a good performance in the period ahead. If the Board met in three months to consider the overdues, it would have to meet only a short time afterward to take up the possible rights accumulation program for Sierra Leone. In order to save the Board's time, perhaps both items should be taken together, in four months' time. That would also allow the Board an opportunity to review in more detail the performance of Sierra Leone. As Directors had observed, some actions had been taken only recently, and some time would be needed before their effect could be adequately judged. The Board should also encourage the authorities to take more actions in the adjustment process to ensure the sustainability of their program.

The authorities in Sierra Leone would continue to explore ways of strengthening their fiscal policy, in order to narrow the deficit, Mr. Mwananshiku continued. Some measures toward that end had already been taken, and the authorities wished to strengthen them. However, it needed to be borne in mind that incomes in Sierra Leone, as in many other African countries, were very low, and the room for strengthening fiscal policy could be quite limited. Of course, the diamond mining and fisheries industries were important, and he had taken note of the comments made by Directors in that regard, which he would convey to the authorities.

He supported the Chairman's suggestion that the Chairman should communicate with the authorities on the question of the rights accumulation program, Mr. Mwananshiku concluded. It was important that the views of the Board be conveyed to the authorities by the Chairman.

The Chairman said that, with respect to the period until the next review of Sierra Leone's overdue financial obligations, he wondered whether Mr. Mwananshiku could go along with the consensus of the Board, and agree to hold the review in three months, not four. Before the Interim Committee came to a decision on the issue of the rights approach at its next meeting, it might be helpful for the Board to be able to have come to firm conclusions on the arrears situation of Sierra Leone. If Sierra Leone's situation had improved by that time, it might be taken by the Interim Committee as an encouraging sign.

Mr. Mwananshiku said that he could go along with the consensus.

The Executive Directors approved the following decision:

1. The Fund has reviewed further the matter of Sierra Leone's continuing failure to fulfill its financial obligations to the Fund in the light of the facts and developments described in EBS/91/1 (1/4/91).

2. The Fund deeply regrets the continuing failure of Sierra Leone to fulfill its financial obligations to the Fund, which places a financial burden upon other members and reduces Fund resources needed to help others, and the continued increase in the amount of Sierra Leone's arrears to the Fund. The Fund acknowledges the recent payments made by Sierra Leone and notes the intention of the Sierra Leonean authorities to make regular monthly payments to the Fund. The Fund urges Sierra Leone to give the highest priority to increasing substantially its payments and to settling fully and promptly Sierra Leone's arrears to the Fund.

3. The Fund notes and regrets the slippages in the implementation of the economic adjustment policies instituted earlier this year, and welcomes the intention of the Sierra Leonean authorities to effect the rapid adoption and implementation of corrective policy measures. The Fund urges the authorities to implement fully their adjustment policies and to adopt as a matter of urgency a comprehensive economic program that could lay the foundations for a rights accumulation program and

help establish favorable conditions that would encourage external donors and creditors to support Sierra Leone's adjustment efforts. The Fund continues to cooperate with Sierra Leone in support of the authorities' efforts to adopt and implement a comprehensive adjustment program.

4. The Fund will review the matter of Sierra Leone's overdue financial obligations to the Fund within three months from the date of this decision, in light of the actions taken by Sierra Leone in the meantime regarding settlement of its arrears to the Fund and the implementation of a comprehensive adjustment program.

Decision No. 9629-(91/5), adopted
January 11, 1991

3. PAPUA NEW GUINEA - 1990 ARTICLE IV CONSULTATION, AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1990 Article IV consultation with Papua New Guinea and the review under the 14-month stand-by arrangement for Papua New Guinea approved on April 25, 1990 (EBS/90/213, 12/12/90). They also had before them a statistical annex (SM/90/229, 12/17/90).

Mr. Evans made the following statement:

The Papua New Guinea authorities welcome the opportunity provided by the annual Article IV consultations to review their economic performance and examine medium-term prospects for the economy. The most recent consultations incorporated a midterm review of performance under a 14-month stand-by arrangement which remains undrawn--a testimony in part to the strength of the adjustment efforts of Papua New Guinea to date.

Closure of the Bougainville mining operation in 1989 and depressed world commodity prices for many of its agricultural exports led the Papua New Guinea authorities to implement a comprehensive medium-term adjustment program focusing on macroeconomic stabilization and structural reform measures. The tighter fiscal, monetary, and wages policies were reflected in depressed economic activity and a decline in real growth in 1990, though private investment remained robust. The staff and authorities are projecting real growth in 1991 of the order of 8 percent, largely based on construction of the Kutubu oil project and increased production and/or improvements in other mining projects. Although the agricultural sector is expected to remain depressed during 1991, spin-off activities from the mineral projects, such as construction, secondary manufacturing, transport and service industries, will all contribute to real growth of 3 percent in the nonmining sector. The external current account deficit is expected to widen in 1991, reflecting a strong increase in imports associated with mine construction, which more than offsets strong growth in mining exports, but the overall balance of payments is expected to be near balance. The Papua New Guinea authorities do not envisage any need at this stage for recourse to Fund resources under the stand-by arrangement which expires in June 1991.

From 1992 and into the mid-1990s, the external outlook is considerably brighter. The coming on stream of further mining projects is expected to lead to strong growth in mining exports (and tax revenue) over the next several years, and the overall balance of payments is expected to record surpluses despite lower net capital inflows. There remains a need to promote the diversification of the nonmining sector to ensure a more broadly-based economy and a sustainable rate of growth in the medium to longer term. As such, the intention is to continue the prudent approach in macroeconomic policy as well as pursue ongoing structural reforms.

Fiscal policy will remain tight in 1991. The underlying fiscal position is expected to strengthen despite an increase in the recorded overall budget deficit. The latter reflects the effects of the Special Intervention Program (SIP) designed to alleviate the social costs of adjustment. The authorities have indicated that SIP will only go ahead if external assistance is forthcoming. In the absence of SIP, the budget deficit would have fallen to below an estimated 1 percent of GDP, reflecting continued expenditure restraint and the 1991 budget revenue measures. The authorities have indicated that any unforeseen additional budgetary expenditures in 1991 will be met by compensatory revenue measures or further cuts in existing expenditure programs. Monetary policy will be kept appropriately firm while allowing for some accommodation of the expected faster growth in private sector demand. In looking to maintaining international competitiveness, emphasis will be placed on wage restraint, and a further decline in real wages of 2 percent to 3 percent in 1991 is expected.

A comprehensive program of structural reforms forms an important part of the adjustment efforts. A number of reforms have already been initiated, and further measures will be implemented in 1991, including further agricultural reforms aimed at improving productivity, promoting and facilitating private investment, and improving public sector resource management. The latter involves a large-scale restructuring of the civil service, including large public service retrenchments. In the area of foreign investment deregulation, it is expected that interim regulations will be submitted to the Cabinet in late February 1991. Efforts are also being focused on broadening the tax base, shifting some burden of taxation from direct to indirect taxes, reorienting indirect taxation toward consumption, and improving the structure of public expenditure. Privatization of a number of public enterprises is planned, and, although measures have lagged behind the original timetable, the authorities have undertaken to submit to the Cabinet by late February 1991 a comprehensive list of government assets and a draft policy framework. They are being aided in their structural reform efforts through financial assistance from the Asian Development Bank and the World Bank.

The Papua New Guinea authorities have shown the ability to exercise sound macroeconomic management of their economy over the past few years, and have successfully contained the rate of inflation and reduced the budget and current account deficits. They are now facing a period of very strong growth associated with the growth in mineral production and exports. The authorities recognize that this will continue to imply the need for sound and prudent macroeconomic policies and structural reforms.

The Papua New Guinean authorities had met all performance criteria to end-September 1990. However, a higher than programmed budget deficit in 1990 has led them to request a small modification of the ceiling on net credit to the government for end-December 1990. In addition, and partly as a result, an increase in net credit to the government, as well as net domestic assets of the banking system for March 1991, is also being requested. As the staff notes, these modifications will not impede the achievement of the objectives of the original program, as overall financial policies will remain firm.

Mr. Ismael made the following statement:

Let me commend the Papua New Guinea authorities for their unwavering pursuance of the stand-by arrangement to contain the adverse impact of exogenous shocks experienced in 1989. In particular, I am pleased that all the quantitative performance criteria for June and September 1990 have been met, and no drawings have been made under the stand-by arrangement.

Although not entirely unexpected, it is nevertheless unfortunate that economic activities in Papua New Guinea continued to be depressed in 1990. This brings into focus the structural and institutional weaknesses that have held back activities in the nonmining sector. In addition, the depressed level of economic activity resulted in slippages in the government budgetary position, creating the need for domestic bank financing in the second half of the year. Nevertheless, I am rather surprised by the statement in the staff report that a seasonal shortfall in revenue would lead to a projected increase in net credit to the government in the first quarter of 1991. I would have assumed that the element of seasonality had been considered in the original program.

However, I am encouraged by the corrective measures being undertaken by the authorities, as outlined in the Memorandum on Economic and Financial Policies for 1990-1991. The program that now follows should, therefore, be seen as the authorities' determination to continue with the adjustment effort to reduce the structural imbalances, sustain financial stability, and stimulate resumption of adequate growth. I have, therefore, no difficulties in supporting the proposed decision.

While I generally concur with the staff's assessment and policy recommendations, I am not as optimistic as the staff with regard to real GDP growth--namely, an envisaged turnaround of the growth rate from minus 1.5 percent in 1990 to plus 8 percent in 1991. I doubt whether the nonmining sector could improve substantially during the year, while the prospect of an improvement in the mining sector does not appear to be bright either. It might, therefore, be more prudent if the authorities were to develop contingency measures for timely implementation in case of a less favorable performance.

I believe that the success of the program depends, first and foremost, on a continued reduction in the overall fiscal deficit, which I understand could be achieved mainly through revenue measures and expenditure restraint. The program has, therefore, rightly placed emphasis on austerity and further efforts to effect a fiscal restructuring. If the longer growth target is to be sustained, any slippages in containing current expenditures should be avoided; at the same time, public spending should be redirected toward promoting private sector growth and human resource development, as suggested by the staff.

I welcome the authorities' commitment to a continued pursuance of monetary and credit policies that are consistent with price and external viability and accommodative toward the expected faster growth in private sector demand. I would like to caution, however, that although inflation is expected to moderate, it is still high, and remains a cause for concern. Therefore, the authorities' vigilance is called for in containing domestic liquidity to levels that would not renew upward pressure on prices. Equally important, increased efficiency in the banking system should help achieve higher productivity in the overall economy. In this regard, the authorities' plan for Fund technical assistance to assess the scope for more instruments of monetary control and improvement in the operations of the financial markets is a move in the right direction.

Looking ahead, the economy remains vulnerable, especially to changes in the terms of trade. Clearly, the sensitivity of the medium-term projection of developments in the mining sector, as described in the staff report, calls for an intensification of efforts to diversify the economy. It is, therefore, very important that the authorities, while expeditiously pursuing structural reform, take advantage of the favorable situation to lay a solid basis toward reducing Papua New Guinea's heavy reliance on the mining sector. I would, therefore, urge the authorities to move ahead rapidly with their reform plan.

It is also imperative that both domestic and exchange rate policies be geared in the direction of maintaining international competitiveness in the nonmining sector. This would supplement the authorities' recent liberalization of the regulatory framework, and attract new enterprises and direct foreign investment.

Finally, the staff has rightly pointed out that Papua New Guinea will still have to rely on foreign grants and official long-term concessional assistance. Every effort must be made to ensure that the country's financing requirements will be met in an adequate and timely way. In this connection, it is disturbing to note the delay in financing inflows over the past year, and I wonder whether the staff could give us some clarification of this matter.

Mr. Ishikura made the following statement:

After the setback in 1989 caused by the closure of the Bougainvillea mine and the unfavorable developments in world commodity prices, the economic situation of Papua New Guinea deteriorated. Real GDP declined by 1.5 percent in 1989, and is estimated to have declined further--by 1.6 percent--in 1990. The current account deficit has reached about 11 percent of GDP. However, the outlook for 1991 and after remains relatively favorable, although dependent on the performance of the mining sector. In 1991, real GDP growth is expected to resume. While the current account deficit is anticipated to widen, owing partly to the higher oil import bill, a substantial capital inflow is expected. Furthermore, it is encouraging that the Government has a positive attitude toward structural adjustment, and has been continuing its comprehensive adjustment efforts with assistance from the Fund, the World Bank, and other multilateral and bilateral donors. We are in broad agreement with the staff's appraisal.

We welcome the Government's intention to maintain a tight fiscal and monetary policy stance and to preserve the competitiveness of the economy. However, the performance criteria on net credit to the government for December 1990 were not met, owing mainly to a larger than programmed fiscal deficit.

The overall budget deficit in 1991 is projected to be 1.8 percent of GDP, which is somewhat higher than the deficit of 1990. Admittedly, this increase in the deficit comes mainly from the special intervention program, but it is imperative to keep up the efforts to strengthen the revenue base and to restrain expenditure. On the revenue side, the authorities have introduced new measures in the 1991 budget, including a 3 percent excise duty on manufactures, a change in the basis of import duties from an f.o.b. to a c.i.f. basis, and tighter income taxation on fringe benefits. While we welcome these measures, the authorities should also look into whether additional revenue can be generated from the mining sector, which may have higher profitability in the future. On the expenditure side, there is a clear need to keep the restraint on administrative costs, accompanied by a rationalization of public services. To support the fiscal adjustment, the authorities should pursue the reform of public enterprises, including privatization. Furthermore, the rationalization and improvement of agricultural commodity stabilization funds, particularly for the coffee, copra, and palm oil industries, should be encouraged in order to avoid an unsustainable burden on the public finances.

These fiscal measures should lead to restraint with regard to the use of bank credit by the public sector. This, together with a tight stance of monetary policy, will promote efficient allocation of credit to the private productive sector.

In the area of structural adjustment, wage policy is of key importance in the present adjustment process. Wage restraint should be maintained to raise profitability and competitiveness in the traded goods sector and to avoid a wage-price spiral.

Regarding exchange rate policy, we can support the devaluation in January 1990 as a complementary measure to support the adjustment policies. This being said, we share the staff's opinion that the authorities' intention to maintain the value of the kina in relation to the basket peg is appropriate. This policy should be accompanied by tight fiscal and monetary policies and appropriate structural reforms to safeguard competitiveness.

In the external sector, the medium-term balance of payments outlook is favorable, even if the Bougainvillea mine remains closed. While the current account deficit is projected to widen to 15.9 percent of GDP in 1991, it is expected to fall to 3 percent of GDP in 1995. As the staff noted, however, this favorable projection is sensitive to mining sector developments and mining export prices. While the mining sector will continue to be a driving force for growth in the coming years, the authorities should pursue economic diversification to attain steady and stable economic development. At the same time, the authorities should keep a close watch on developments in the export sector, and be prepared to take additional measures, if necessary.

In conclusion, Papua New Guinea has great potential, in particular as regards its mining resources. The authorities have been continuing their adjustment efforts to make full use of their economic potential. Now they are facing a crucial period, in which they will have to address the short-term internal and external imbalances and provide an appropriate environment for economic developments planned for subsequent years. We encourage the authorities to persevere with the program. I support the proposed decision.

Mr. Scheid made the following statement:

We welcome the satisfactory implementation of the program so far. Considering the serious exogenous shocks Papua New Guinea's economy suffered last year, it is certainly no small achievement that domestic and external financial imbalances were largely contained to the levels before the shocks occurred. Moreover, it is most gratifying to note that in reaction to the better than expected external position, the authorities have not drawn under the stand-by arrangement, relying instead on the confidence-inducing and catalytic effect of their Fund-supported program.

As to the plans for 1991, I am broadly satisfied with the program objectives, in particular if seen against the prospective strengthening of overall performance projected under the medium-term adjustment framework. However, there are a number of developments giving reason for concern that will require close monitoring and possibly a further strengthening of the adjustment effort. These developments include, in particular, the worsening in the inflationary outlook and--probably related to that--the deterioration in the government savings performance, as indicated in Table 5 of the staff report, as well as the recent widening of the interest rate differential in favor of the Australian dollar.

If inflation should not come down as programmed, I therefore would hope that the authorities would promptly reconsider their policy stance in these policy areas.

Another aspect of concern is the lack of progress in diversifying the economy; at least, there is little in the staff's medium-term projections that would suggest significant improvements in the fundamental structural weaknesses of the economy. I therefore strongly endorse the authorities' intentions and the staff's recommendations related to the promotion of private sector investment and human resource development in the nonmining sector. The success of those intentions and recommendations will of course critically depend on the availability of sufficient domestic savings.

I can support the staff appraisal and the proposed decision.

The staff representative from the Asian Department stated that the program supported by the stand-by arrangement had been successful in restoring financial stability and in catalyzing donor assistance especially for structural adjustment programs, some of which were still to be implemented in 1991. There had been some delays, but the staff expected the concessional assistance to arrive in the course of 1991. The program had also helped to restore the confidence of foreign investors, and new mining projects had proceeded rapidly over the past few months, despite the uncertainties associated with the Bougainville mine. The program was a tight one, but the uncertainties associated with the Bougainville situation and the weak agricultural markets had necessitated a cautious approach.

The main task for 1991 would be to restore economic growth, especially in the private sector, the staff representative continued. To that end, it seemed to the staff that the budget deficit must be contained within the program targets, pressures for renegotiation of wage agreements must be resisted, and the authorities must proceed vigorously with the program of structural reforms. While a number of important structural measures had been initiated, there was still a long way to go. There had unfortunately been some slippages since the staff mission in September 1990.

With regard to civil service reform, while there had been a large retrenchment in the program in effect until September 1990, there had been some increase in employment in the public sector since then, the staff representative commented. The privatization of the public enterprises was not proceeding as quickly as had been hoped. Tax reform, including questions related to the mining sector, still needed to be addressed.

The World Bank economic mission which had visited Papua New Guinea in May 1990 had made some recommendations to restore the momentum in those areas, and would be following up in the period leading up to the Consultative Group meeting in May 1991, the staff representative from the

Asian Department observed. If the momentum of structural reform could be maintained as scheduled, taking account of the good prospects for the mining sector, the medium-term prospects continued to remain favorable.

Mr. Abbott made the following statement:

I would like to commend Papua New Guinea on its forceful implementation of a well-constructed stabilization program to deal with the adverse effects of weakened export prices and curtailment of mineral production. Considerable progress has been demonstrated in limiting public expenditure, increasing wage flexibility, and reducing the civil service. Effective demand-management policies have secured the improvement in external competitiveness introduced by the 10 percent devaluation of the kina in January 1990.

Staff analysis indicates that Papua New Guinea can look forward to improving economic activity in 1991, based substantially on vigorous expansion of private investment in the mining sector. This should provide a favorable background for ongoing efforts at necessary medium-term adjustments. Continuing fiscal consolidation will be required, since external grants, which now provide very substantial budgetary support, are to be phased out. We welcome the reported close collaboration with the World Bank on prioritization of public expenditure, as well as the tax reform measures initiated in the 1991 budget.

Last spring, in our statement of support for Papua New Guinea's stand-by arrangement, we noted the importance we place on efforts to stimulate the nonmining private sector. We believe that this should continue to be a major priority, particularly since the immediate opportunities appear to be tilting the economy toward more, not less, dependence on the mining sector. In the coming year, production, investment, exports, imports, and capital flows will all be more dominated by mining activity. Continued efforts on privatization, regulatory liberalization, wage flexibility, and restructuring of commodity stabilization funds are to be encouraged. We endorse the staff's encouragement of expanded bank lending to the private sector within the program ceiling on net domestic assets of the banking system.

We are pleased to note the positive steps Papua New Guinea has taken in the last year to address environmental damage caused by commercial mining and logging operations. This is a matter of high priority for my authorities, and any additional information the staff could provide on the effectiveness and economic impact of environmental measures would be welcome.

In light of Papua New Guinea's record of prudent economic management, its steady application of stabilization policies, and its continuing commitment to the structural adjustment program, we support the proposed decision.

Mr. Menda made the following statement:

Like previous speakers, I would like to commend Papua New Guinea's authorities for their prompt reaction when the closure of the Bougainvillea mine provoked dramatic changes in the economic situation. The restrictive financial policies supported by the stand-by arrangement adopted last year have allowed a more severe deterioration to be avoided. We welcome the fact that all performance criteria for June and September 1990 have been met. Furthermore, no drawings have been made under the arrangement, which gives to this agreement the original character of a precautionary line of credit.

I agree with the staff that the underlying fiscal position has been strengthened. Two sets of measures contribute to this: first, the size of the civil service has been reduced, and further retrenchment is planned; and second, tax reform measures have been initiated aiming at broadening the tax base and reorienting indirect taxation toward consumption. These, accompanied by restrictive wage policies, should improve the situation in the medium term. Let me add, however, a word of caution, since the overall deficit has overshot the objective by close to 1 percent of GDP, and the target for 1991 has been revised downward. This has led to lower repayments to the banking system and to the proposed revision of targets. Therefore, I fully agree with the staff that the authorities should stick to their medium-term program.

I endorse the exchange rate policy adopted in the wake of the last devaluation. Like the staff, I believe that the policy of stability of the nominal effective exchange rate, accompanied by strict financial policies and wage discipline, has been instrumental in controlling inflation in a period of adverse shocks.

Let me encourage the authorities to pursue structural reforms in order to promote nonmining private sector activities and to improve public resource management. Perhaps the staff could tell us what concrete measures have been planned in order to promote foreign direct investment, which could be an important factor of diversification.

Mr. Noonan made the following statement:

I would first like to join others in commending the authorities for the quick and decisive manner in which they have moved to implement their economic adjustments since late 1989. I also wish to indicate that I support the proposed decision.

Like Mr. Abbott, my remarks will focus on some issues arising from the dual nature of the economy of Papua New Guinea, which comprises a relatively large traditional sector, on the one hand, and a dynamic, modern mining and ancillary sector, on the other. These issues are not new, but the economic adjustments needed to cope with the closure of the Bougainvillea mine in 1989 have brought the dichotomy more sharply into focus.

Most economies experience significant variance in the performance of different sectors. Because sectors can be quite diverse, the resource needs of the dynamic and growing sectors may not provide opportunities for other domestic sectors. Instead, they often provide opportunities mainly for external investors and suppliers. At the same time, and often because of the external source of many of these supplies, the structure of costs associated with rapidly growing sectors tends to be higher than that which can be sustained by the rest of the economy. Most authorities have difficulty in dealing effectively with the problems arising from such diverse sectoral developments and requirements.

Given that the nonmining sector in Papua New Guinea accounts for more than 80 percent of GDP and provides income and employment for the bulk of the population, it is reassuring that the authorities there seem to be having success with the measures they have adopted. Specifically, the devaluation of the kina in January last year should have increased profitability in the tradable goods sector, the adoption of less than full indexation of wages should have brought about some degree of real wage adjustment, and the phasing out of the heavy producer subsidies should reduce price distortions for producers. We also welcome the establishment of a committee to ensure that further measures aimed at trade liberalization, and the promotion of private investment, including the deregulation of the approval system for direct foreign investment, can be implemented expeditiously. Nevertheless, we have some reservations about the sustainability of the required development of the nonmining sector over the medium term, especially if there were to be rapid exploitation of natural resources during the same period.

The issue of economic diversification in relatively small economies which have hitherto been largely dependent on tropical agriculture is of particular interest to this chair, which represents a number of countries that have been trying to tackle this problem for quite some time now. Most, for all practical purposes, still remain dependent on one or two export crops for the bulk of domestic value added and employment.

The statistical annex points out that the main source of livelihood for 80 percent of the population of Papua New Guinea is derived from subsistence agriculture and the commercial production of coffee, cocoa, copra and palm oil for export. The authorities intend to diversify further this nonmining sector, on which such a large proportion of the population depends. This is a laudable objective, but we have some difficulty in reconciling projected real growth of as much as 3 percent in 1991 and continuing real growth thereafter in this sector with the recent experience of a decline in output and a continuing high rate of investment in mining projects and exploration activity. Moreover, available arable land for cultivation appears to be in short supply, while there is uncertainty on the subject of land tenure. We also note the slowdown in growth of world trade in primary commodities and the declines in commodity prices, particularly for tropical agricultural products. We therefore wonder what in fact is envisioned by the phrase "agricultural reforms." Is it that there would be greater use of inputs or changes in farm structures to improve the productivity in the output of traditional crops? Alternatively, is it the intention of the authorities to move into increased production of nontraditional crops for national consumption and/or exports? We would be pleased to have some elaboration from the staff on the scope that is seen for development of the agricultural sector in Papua New Guinea in the medium term.

Mr. Zhang made the following statement:

The Papua New Guinea authorities are to be commended for their successful implementation of the stand-by arrangement, in spite of the unfavorable economic situation in the North Solomons Province and low world market prices for the country's major agricultural exports. The external position of the country has been stronger than initially programmed, and gross official reserves are estimated to be equivalent to nearly five months of nonmining imports at the end of 1990. I am in broad agreement with the staff's appraisal and recommendations.

The authorities adopted a restrictive fiscal policy in 1990, which contributed to the satisfactory performance of the financial stabilization program. It is important to maintain this tight fiscal stance in the year to come. Therefore, the authorities are encouraged to undertake further measures to broaden the tax base and enhance tax collection. Regarding current expenditure, the retrenchment measures taken by the authorities in 1990 would provide opportunities to promote social sectors and public investment programs, especially in infrastructure and human resource development.

We also attach great importance to structural reforms in the fiscal area. The authorities have placed strict controls on administrative costs to improve management of public outlays. The finances of public enterprises have been monitored closely, and administered prices will be adjusted regularly in light of reviews on the cost-price situation. Commercialization of a number of public services has also been carried out. All these measures are essential for increasing the efficiency and raising the productivity of the public enterprises.

It is encouraging to note from the Government's memorandum on economic and financial policies that economic activity is expected to recover in 1991, with real GDP projected to increase by 8 percent. The economic situation deteriorated sharply in 1989, and real GDP is estimated to have declined by about 1.5 percent in 1990. It is therefore crucial that economic growth be promoted while reform measures are undertaken.

We can endorse the staff's proposal on a modification of the December 1990 and March 1991 ceilings on net credit to the government and of the March 1991 ceiling on the net domestic assets of the banking system. We would also join other speakers in support of the proposed decision.

Mr. Prader made the following statement:

The economy of Papua New Guinea has made remarkable progress, by implementing financial stabilization and structural reforms under the present stand-by arrangement. The stabilization program was launched at the end of 1989 in response to a severe deterioration of the economic situation caused by exogenous factors, such as the closing down of the country's main gold and copper mine, and the depressed world market prices for the country's major agricultural exports. The stand-by arrangement approved in April 1990 has been designed to support the stabilization policies and to generate adequate inflows of concessional assistance.

The Government of Papua New Guinea has been implementing successfully its adjustment policies in 1990. The external position has improved, with the current account deficit moving well below the program target, and tight financial policies and wage restraint helped to preserve the competitiveness gained by a 10 percent devaluation at the beginning of 1990. By means of substantial inflows of concessional aid and private capital, international reserves have risen to a more adequate level. However, real GDP has declined further, the rate of inflation has accelerated, and the overall budget deficit for 1990 is expected to be slightly above the programmed level, with lower than expected revenue from taxes, and with expenditures slightly above the scheduled level. Net credit to the government is expected to exceed the targeted ceiling due to the larger budget deficit, while private sector credit is expected to fall below target.

The improvement in the economic situation of the country that was attained during 1990 can be attributed to both the stabilization efforts and adequate inflows of foreign concessional and private resources, which aided in alleviating the social costs of adjustment.

For 1991, the Government projects a strong recovery--an 8 percent increase of real GDP--together with increased mining exports and a sharp rise in imports for both the mining and nonmining sectors. Due to this recovery, a more than 50 percent increase in the current account deficit--to 16 percent of GDP--is envisaged by the end of 1991. Further sizeable net inflows of external resources will be needed for the economy to contain this imbalance. The bulk of these inflows, in the form of private capital, is projected to finance mining developments.

In the context of the projected recovery for 1991, and also of the medium-term prospects of the main sectors in the economy, I believe that two requirements are fundamental to the Government's economic policies in 1991. First, to give assurances on the strengthening of financial stabilization, in order to facilitate continuing concessional assistance and private capital inflows; and second, to accelerate progress in structural reforms in order to boost the rate of growth based on a more diversified and privatized economy.

On the first requirement, a more substantial improvement of the underlying fiscal position should have top priority in 1991. In this context, the projected cuts in administrative expenditures, notably the envisaged reduction in the size of the civil service, should be maintained. The envisaged financing from external assistance for the special intervention programs in the area of housing, health, and education services should by no means be used to pay for deficit financing. This would also help to avoid pressures on excess wage demands.

The second requirement for economic policies in 1991 should be an acceleration of structural reforms in order to strengthen and diversify the economy and to achieve a sustainable rate of growth.

In 1991, the Government will launch structural measures in the fiscal area which will affect the tax system. The early introduction of a complex system of consumption taxation would generate revenues which are necessary for the stabilization of the fiscal position. Experiences show that a value-added type of tax system can serve as an efficient instrument for the desirable broadening of the tax base and for guiding indirect taxation toward consumption.

In the area of rationalization of agricultural stabilization funds, accelerated progress in substituting government-guaranteed credit financing for the present system of subsidies would alleviate the burden on the budget.

The Government's objectives to raise productivity, to stimulate employment, to diversify the productive sectors by promoting new industrial enterprises, and to strengthen the private sector, require a liberalization of regulations for domestic and foreign investors. In this context, an early introduction of the envisaged new legislation on private investments would accelerate foreign direct investments. The Government should also initiate reform measures in several other areas of the economy in 1991. More specific schedules on further steps in such areas as the program to enhance competitiveness in the agricultural sector, including revised financing for commodity stabilization funds, could provide incentives.

I support the proposed decision, including the proposed modifications of the performance criteria.

Mr. Fogelholm stated that, like Mr. Prader, he welcomed the fact that the Papua New Guinea authorities had decided not to draw under the stand-by arrangement. In making that decision, they were joining other countries that had also not drawn under their arrangements, such as Nigeria and Costa Rica, among others. It was encouraging to note that stand-by arrangements were being used by some countries as they were originally intended--that is, as a stand-by, in case of need, and not as a ready source of financing.

He agreed with Mr. Ismael that the growth projections appeared to be overly optimistic, Mr. Fogelholm observed. He wondered whether those projections were consistent with the fact that demand for metals was very price sensitive, and that international market prices for many metals were declining. Perhaps the staff could comment on those points. If the projections were in fact somewhat optimistic, he wondered what, if any, contingencies the authorities were envisaging.

The staff representative from the Asian Department stated that a large part of the total growth in 1991 was expected to come from the mining sector, from the new projects which were underway. In the nonmining sector, expected volume growth was of the order of 3 percent. That pace of growth had been achieved through most of the 1980s, but would still represent quite a turnaround from what had happened in 1989 and 1990. With the measures that had already been taken, and the fact that there was confidence particularly in the mining sector, and some flow-through to the nonmining sector as a result of those developments, the growth projections were not overoptimistic. The authorities would stand ready to take measures during the year if the situation warranted, although they had not formulated any precise measures at present. However, they wished to underline their commitment to the restoration of financial stability, and the staff did not expect them to move away from their current budget quickly. If over the course of the year expectations did not materialize, further measures could be expected.

Over the longer term, the faster growth in the nonmining sector would be dependent on developments in the agricultural sector, the staff representative pointed out. To that end, the arrangement that was being negotiated with the Asian Development Bank was important, both to carry through the various reforms of the agricultural commodity stabilization funds, and to bring in other measures, such as agricultural extension services, research, and improvement of input distribution to support diversification efforts and to achieve the increases in productivity that had been mentioned in the staff report.

The first essential step in the promotion of foreign direct investment was the introduction of the new investment promotion authority, which would replace the existing regulatory body, with an emphasis on encouraging private sector investment in general, and foreign direct investment in particular, the staff representative continued. Legislation was intended to be introduced in Parliament, but Parliament would be in recess until July 1991. The authorities were looking at ways of introducing the new investment body in the meantime, through nonlegislative measures.

The authorities were clearly paying more attention to environmental issues, particularly with regard to mining and logging, the staff representative from the Asian Department concluded. Recent developments not mentioned in the staff report included steps to implement the recommendations of the tropical forestry action plan; a departmental group was looking at ways to implement most of the recommendations, to which the Government had agreed in principle. Some follow-up work by the World Bank included a project currently underway to establish a system of environmental accounting within the Environment Department. The World Bank also intended to undertake an environmental impact assessment within the following few months.

Mr. Evans thanked Executive Directors for their comments, which he would convey to the Papua New Guinea authorities. Papua New Guinea's success story was a pleasure to him. The Papua New Guinea authorities had put a great deal of effort into their adjustment program, and their success showed what could be done if a government really puts its mind to adjustment.

He shared the concerns of Directors regarding the fiscal outlook for 1991, and would certainly draw that to the attention of the authorities, Mr. Evans continued. As the staff had indicated, the budget deficit was increasing, at least superficially, because of the safety net program which was to be financed by concessional external financing. Such a combination, when put into an existing budget, could not but lead to an increase in the deficit. The question then was whether fiscal policy should be adjusted to offset the effect of the safety net. In his view, that would not make much sense; it would not be consistent, for example, with Mr. Ismael's concern that growth in 1991 might be less than was indicated by the staff, and that the authorities should be ready to react to that. If the short-term elements of the fiscal policy for 1991--such as the safety net--were taken into account, then the situation appeared to be manageable.

There appeared to have been some slippage recently on public sector employment, but the figures were very uncertain, Mr. Evans pointed out. It was encouraging, however, that the matter had come to light so quickly, and that the authorities had it under notice.

Some interesting issues were raised by Mr. Noonan; they were not unlike those that Mr. de Groote had raised in the previous year on dual economy problems, Mr. Evans recalled. Those problems were very difficult to deal with. Obviously, Papua New Guinea was fortunate in having abundant natural resources at its command. There was clearly scope for improvement in the nonmining sector, particularly in traditional agriculture, where there was room for an enormous increase in productivity. That scope could be seen, for example, by comparing copra production in Fiji with the production in Papua New Guinea, as the amount of land dedicated to raising it was about the same in each country. The combination of policy that was being applied in Fiji--better management techniques, better agricultural techniques, and the removal of the stabilization funds to apply greater competitive pressures--seemed to be the right way to go. He would expect that such a combination of policies would lead to increased output in Papua New Guinea as well.

The Chairman made the following summing up:

Directors commended the authorities on the adjustment strategy that they had steadfastly pursued since mid-1989, in response to the shocks stemming from the closure of the Bougainville mine and low world prices for major agricultural exports. While real GDP had declined and the rate of inflation had increased, the external position had been stronger than initially envisaged. Tight financial policies, wage restraint, and a depreciation of the exchange rate had helped to strengthen competitiveness. Directors noted that no drawings had been made under the stand-by arrangement, and that none were foreseen in view of the better than expected external reserve position.

Directors welcomed the prospect of a resumption of economic growth in 1991, largely based on mining projects. Speakers believed that there certainly was no room for relaxation of the adjustment effort, and they encouraged the authorities to stand ready to implement contingency measures in case developments would be less favorable than anticipated, or if the expected decline in real wages would not be forthcoming. The budget deficit would be somewhat higher than last year, but Directors noted favorably the cuts in administrative expenses, including a reduction in the size of the civil service, which would strengthen the underlying fiscal position. The government's net repayments to the domestic banking system would permit a faster rate of growth in private sector credit, without undue expansion in total domestic credit.

Directors assessed the medium-term balance of payments as favorable, in view of the expected strong growth in oil and mining exports from new projects, even if the Bougainville mine did not reopen. The overall balance of payments was expected to move into surplus from 1992 onward, and the external debt situation should remain manageable. Directors endorsed the authorities' intention to maintain stability in the nominal exchange value of the kina in relation to a currency basket peg. However, Directors stressed that the prospective strengthening of the external position had not diminished the need to strengthen and diversify the nonmining sector, and thereby generate employment and achieve faster progress in poverty alleviation. They urged the authorities to implement vigorously the program of structural reform that had recently been initiated.

Directors attached importance in the fiscal area to strengthening efforts to improve the equity and efficiency of the tax system by broadening the tax base and reorienting indirect taxation toward consumption, and to containing the public sector wage and salary bill and redirecting spending toward social infrastructure and human resource development. Along with efforts to contain costs, public enterprise prices needed to be adjusted promptly to sustain profitability in the face of higher fuel costs. Speakers also attached importance to faster progress with regard to improvements in the structure of public enterprises and the privatization of a number of these enterprises. Directors said that the rationalization of the agricultural commodity stabilization funds should be completed expeditiously to avoid an unsustainable burden on the public finances and the banking system.

It was recommended that the next Article IV consultation with Papua New Guinea be held on the standard 12-month cycle.

The Executive Board then approved the following decision:

1. Papua New Guinea has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Papua New Guinea (EBS/90/61, Sup. 2).

2. The letter and attached memorandum from the Minister for Finance and Planning and the Governor of the Bank of Papua New Guinea dated December 11, 1990 shall be attached to the stand-by arrangement for Papua New Guinea, and the letter and attached memorandum dated March 23, 1990 from the Minister for Finance and Planning and the Governor of the Bank of Papua New Guinea shall be read as supplemented and modified by the letter dated December 11, 1990.

3. Accordingly, the limits referred to in paragraph 4(a)(i) and (ii) on net credit to the government of the banking system for the end of 1990 and the end of March 1991 and net domestic assets of the domestic banking system for the end of March 1991 shall be as specified in the table attached to Annex I of EBS/90/213.

4. The Fund decides that the review contemplated in paragraph 4(b) of the arrangement is completed and that, notwithstanding paragraph 4(a) of the arrangement, Papua New Guinea may proceed to purchase up to the equivalent of SDR 20.5 million.

Decision No. 9630-(91/5), adopted
January 11, 1991

4. KINGDOM OF THE NETHERLANDS - ARUBA - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with the Kingdom of the Netherlands - Aruba (SM/90/223, 12/6/90). They also had before them a background paper on recent economic developments in the Kingdom of the Netherlands - Aruba (SM/90/234, 12/27/90).

Mr. Hogeweg made the following statement:

The Aruban authorities highly appreciate the Article IV consultation discussions with the Fund and the high level, impartial economic analysis, and advice which the discussions provide. They basically agree with the assessment of Aruba's current situation and prospects as described in the staff report, as well as with the policy recommendations.

Aruba's history over the past few years provides a vivid illustration of the difficulties of managing a small island economy, with limited areas of comparative advantage, in a world of fluctuating fortunes. It is only six years ago that the fall in oil prices in the mid-1980s led to the closure of the large oil refinery on the island and to a heavy blow to the tourist industry, which, at the time, was highly dependent on Venezuela. All at once, the foundations on which the economy was built disappeared.

Based on Fund staff advice, the authorities acted swiftly and decisively. Financial disequilibria were contained, wage cuts boosted competitiveness, and a system of government guarantees set in motion an investment boom in new hotel capacity, which subsequently managed to maintain high occupancy rates. Chart 1 in the staff report illustrates the resulting economic activity.

In retrospect, however, it appears that too many contracts for new hotels were concluded. There are now severe strains on physical infrastructure and clear shortages of labor, and existing contracts will lead to further hotel construction in the next few years. While all hotels are private ventures, the government has a clear stake in their success due to the guarantees which have been granted. The main threat to their success is the overheating of the economy and the extremely tight labor market, with the consequent risks that rising labor costs will undermine Aruba's competitive position. The situation is of course aggravated at the present time by the weakening tourism market in the United States.

Hence, within a very brief time span, economic policies in Aruba have had to deal with very different situations and requirements, and it has in some cases proven difficult to reorient policy directions in a timely manner. At present, the oil refinery is being prepared for reopening, which will add to labor market pressures. The authorities agree with the staff that there is at present no capacity to further diversify the economy, although it remains an important longer term goal. They also fully recognize the importance of setting clear priorities in investments in infrastructure, the need for fiscal prudence and monetary restraint, and, more generally, the need to increase savings in the economy. The budget for 1991, which is now before parliament, has succeeded in limiting the growth of current expenditures to 5 percent, and expenditure control has been strengthened in order to achieve the envisaged surpluses in the current balance. The Centrale Bank van Aruba has already made public that accelerating wage and price inflation and the need to maintain an adequate level of reserves may call for an increase in domestic interest rates and/or a lower growth rate of bank credit to the private sector in 1991 than the 15 percent agreed on for 1990. Details will be decided shortly.

The medium-term scenarios provided in the background paper on recent economic developments convincingly show the crucial role of labor market policies in reaping the opportunities Aruba has created for itself. Here again, the authorities are fully aware that the extreme shortage of labor may undermine the competitiveness of the tourist industry, both in terms of costs and of quality of service, and that large-scale immigration of foreign labor will be necessary. At the same time, some checks on qualifications, such as language skills, of foreign workers are deemed necessary to maintain quality, and some spreading of the origins of foreign immigration may help to maintain social balance. The authorities are currently assessing in detail the necessary number of immigrants.

The Aruban economy is indeed again at a crossroads. The complexity of the requirements of policies comes out clearly in the appendix to the background paper on recent economic developments, which illustrates some of the interrelationships involved. A Council of Economic Advisors has been instituted in 1990 to help formulate policies in a medium-term context. The authorities are determined to keep Aruba on a successful course.

Expanding on his statement, Mr. Hogeweg commented that the authorities would like to draw the attention of the Board specifically to their recent decision to assist local unions in establishing a pension fund for the private sector, in an effort to seek more restraint in union demands for higher wages. Immigration policy for 1991 would be similar to that of 1990, with permits being processed as expeditiously as possible, and with most permits being accepted. Nevertheless, an unbridled wave of immigrants into the small island economy would be prevented.

The Council of Economic Advisors was expected to finalize its five-year plan for 1991-95 in the current month, Mr. Hogeweg continued. The plan would include an adjustment of intended public sector investment expenditure to amounts compatible with internal and external balance. Furthermore, the authorities had confirmed that monetary policy would aim for continued growth of international reserves in line with the growth of import payments, by limiting domestic money creation. Interest rate policy was intended to reinforce the credit ceilings. One concern in that area was the cost of housing needed for the expanding labor force.

The authorities recognized that price controls were not a basic solution to the problem of inflation, Mr. Hogeweg concluded. However, they had been installed for some basic necessities for psychological reasons and, specifically, to moderate wage demands.

Mr. Noonan made the following statement:

> I would like to commend the staff on their succinct and yet easily read report. I agree with the staff that the current boom in Aruba involves significant risk, and could endanger balanced and sustainable economic development. Presumably, the reference to balanced and sustainable development refers to the potential for such development in the future. The prevailing situation, I fear, seems more akin to the boom phase of a "boom and burst" cycle.
>
> Not only are there the risks associated with excessive demand, but it seems to me that there may be a significant risk that some of the government guarantees, incurred in generating this boom, will be called upon. Admittedly, current arrangements make it unlikely that they will be called upon before 1992, but nevertheless, at 29 percent of GDP, these guarantees represent a substantial future risk to the public finances. If, in addition, the government extends its guarantees to cover cost overruns, the background paper on recent economic developments estimates that the public finances will be exposed to the extent of another Af 50 million, or a total of some 33 percent of GDP.
>
> On the assumption that debt-service payments are guaranteed over the life of the loan--presumably up to 20 years, although the staff might confirm this--that would leave the public finances very exposed over a long period of time to either any downturn in overall tourism, reflecting recession in the United States or in Venezuela, where many of Aruba's tourists seem to come from, or increased competition from lower cost locations, or both factors operating together. For that reason, I commend the planned setting up of a guarantee fund to protect against the potentially disruptive consequences of any massive calling upon of these guarantees in the future. I would also hope that the authorities will be able to successfully negotiate better burden sharing arrangements with the hotels, and to strengthen incentives for the hotels to succeed commercially.

As regards financing the planned guarantee fund, I would suggest that some contribution should be obtained from tourism expenditure in Aruba, which has grown massively in parallel with the growth in tourist overnight stays, now in excess of 3 million a year. In that context, I agree with the staff that there is scope for greater revenue generation from indirect taxes, which would help to spread the burden of providing government services more equitably between residents and tourists. Furthermore, any shift in the overall taxation burden from direct to indirect taxes would likely encourage greater participation in the labor market.

I would share some of the authorities' reservations about the social risks attached to large-scale immigration. As I understand the position, many of the construction contracts are of a turn-key nature, with both materials and labor imported by the contractor. The workers come from countries such as the Dominican Republic, where pay rates are relatively low, and subsequently return to those countries. This type of arrangement alleviates local cost pressures and avoids the social implications of substantial immigration. This helps to explain why the cost of providing a hotel room in Aruba, at some $100, is not very different from the provisions of comparable rooms in lower-cost Caribbean countries such as Grenada and Antigua. Cost differences, however, are likely to arise in the day-to-day operation of those hotels, and it is here that there may be risks arising in the longer term from the authorities' guarantees in respect of hotel debt-service costs. On the issue of the tight labor market, the staff report notes that the government and its enterprises are still absorbing substantial numbers of the labor force, albeit at the lower skill levels. The authorities quite rightly have recognized that a shakeout at both the central government and parastatal levels would be desirable, and this should further improve the supply of domestic labor to other sectors, and relieve somewhat the tightness in the labor market.

Nevertheless, the scale of recent developments has been so great that inflationary pressures arising from excess demand have been unavoidable. Consequently, policies aimed at diversification of the economy are hardly appropriate at this time. Of course, jobs in hotels, construction, and public services are unlikely to match the aptitude of all Arubans, notwithstanding the island's comparative advantages in the tourism sector. Diversification of the economy must therefore be a desirable longer-term objective. The only point we wish to make is that now is not the appropriate time to actively pursue diversification of the economy. We are pleased to note from Mr. Hogeweg that the authorities are in agreement with the staff that there is at present no capacity to further diversify the economy, although this remains an important longer-term goal.

I can certainly agree with the staff that the imposition of price controls on basic necessities in the apparent absence of monopolistic conditions is unlikely to be successful. Instead, it could well hamper effective competition at both the retail and wholesale levels. I suspect that the psychological effect referred to by Mr. Hogeweg could as likely be adverse as benign.

On the issue of wages, I fully share the view that the growth in pay levels poses considerable risks. However, I would have some hesitation about the credibility of a wage pact based on later profit sharing and social benefits, under which current wage restraint would be seen as increasing profits in the short term, mainly for the perceived benefit of foreign financiers and entrepreneurs, with no guarantee that the same people will not be later making claims on the government in the future on the basis of their debt-service guarantees. Those claims on the public finances could well compete directly with the resources available for workers' old age and health coverage. Some trade-off against lower direct taxation would seem a more promising and credible strategy. Again, this reinforces the case for a switch in the overall tax burden toward indirect taxes and away from direct taxation. On the issue of profit sharing, I would like to know what experience there has been of its successful application in Aruba.

With regard to monetary policy, I would have some sympathy for direct credit controls rather that indirect measures, in an economy as small as Aruba's, where the development of financial and capital markets remains very much at a rudimentary stage.

Ms. Montiel made the following statement:

The economic performance of Aruba during the last four years has been remarkable. Real GDP growth was in the double digits, and the unemployment rate was only 1.3 percent in 1990. The decisive and prompt action of the Government in implementing adjustment measures and promoting accelerated growth in the tourism sector helped to restore external and internal confidence in Aruba's economy and propel its growth. However, the boom in the tourist sector, compounded by the easing of fiscal policy, has led to the overheating of the economy, as is shown by recent economic indicators--the tightness in the labor market and the increasing inflation rate, in particular. In this framework, the answer to the policy dilemma faced by the Aruban authorities--which has been well described by the staff--is very difficult. In that regard, an immediate solution of the labor market imbalance is required in order to achieve financial equilibria and to support private investment. Although we understand the concern of the Aruban authorities with respect to easing the immigration policy, and in connection with all the possible problems of dealing with a decline in population growth of around 10 percent in the short run, the development of the tourist sector must be sustained, and Aruba's competitiveness in that sector maintained. At the same time, the immigration policy should be supported by the elimination of overstaffing in the government sector, and a conservative wage policy for public employees.

During 1991, the development of infrastructure needed to support the development of tourism and the population increase warranted a reduction in current government expenditures. In that regard, we welcome the new ordinance to contain government expenditure. On the revenue side, the strengthening of the tax collection system and the broadening of the tax base will be instrumental in keeping fiscal discipline. Uncertainties about the sustainability of the fiscal adjustment have been reduced by the creation of a guarantee fund as a hedge to any possible calling upon of the government guarantee on external loans to finance hotel investment projects.

The expansion in government expenditures and the maintenance of the exchange rate requires a very extreme and stringent monetary policy. Although we concur with the views of the authorities and the staff about the short-run effects of credit controls in limiting the expansion of the money supply, credit controls will affect adversely the allocation of resources. A greater reliance on interest rates will help to increase private savings. Excess liquidity in the banking system and the lack of competition pose some difficulties for the effectiveness of the interest rate, which has been appreciating in real terms over the last few years.

We would appreciate some comments from the staff about the possibility of mopping up the excess liquidity in the banking system; about the sustainability of the exchange rate; and about the ability of the monetary authorities to sterilize capital inflows, given the accumulation of international reserves. We would also appreciate some information about the possibility of increasing competition in the banking system and the status of the offshore banking sector.

Mr. Spencer made the following statement:

Overall, I would concur with the staff's analysis and prescription for a more cautious and balanced development strategy for Aruba.

The key problem that has been highlighted by the staff and earlier speakers is the labor supply bottleneck, which threatens to undermine Aruba's impressive growth performance of the past four years.

This highlights the need for development strategies to be clearly thought through before they are undertaken. More specifically, the Aruban authorities should have been considering both the infrastructural and social implications of further rapid development before the most recent batch of hotel contracts were undertaken. Now that the contracts have been written, there is really no alternative but to allow more immigration, if the Government is to avoid major reversals in the growth strategy and in its own finances.

Even aside from the labor market problem, the fiscal incentives underpinning the growth strategy must be of increasing concern to the authorities. While these arrangements may possibly have been warranted in the early years of the growth strategy--based on some sort of infant industry argument--their full long-term cost is now becoming more apparent.

The Government is now in the position of having to accept the downside risk not only of its own infrastructure diversification investments, but also of the private tourism investments in the pipeline that will become increasingly marginal in the face of a weakening U.S. and world economy.

It is mentioned in the staff report that there may be an opportunity to renegotiate the guarantees. If this is the case, the Government should make every effort to reduce the present high exposure of the Aruban taxpayer.

While the hotel guarantees are a threat of great concern to the public finances, there is a clear indication in the staff report that the incentives given to nontourism projects have been even more dubious. In this respect, I would be interested to hear from staff whether the refurbishment of the oil refinery and transhipment facilities would have any likelihood of a positive economic return in the absence of the subsidies. The point to emphasize is the very great danger of formulating national investment priorities on an ad hoc basis, rather than in the context of a comprehensive analysis of economic risk and return. Certainly, the aim of diversification should be considered very carefully before being used to justify projects with a low or negative return.

If the aim of the authorities is to reduce the volatility of national income, then the staff's proposal of a reserve fund would likely serve the purpose, while also yielding a good rate of return. If the aim is to ensure against falls in employment, rather than just falls in income, then I do not see that large capital-intensive investment projects, such as the oil refinery, are likely to have any advantage over a diversified investment portfolio.

Turning to financial policies, the staff points out that fiscal policy is caught between meeting the needs of infrastructural development and the need to restrain the excess demand and inflationary pressures in the economy.

In a situation in which public sector projects are shown to make a good market rate of return, I would not be too concerned about the fiscal deficits projected for coming years. There is nothing wrong in principle with public and national dissaving, if the associated investment is earning a return to cover the debt-service costs.

However, the public and national dissaving in Aruba is driven by investments that are in many cases dependent on government fiscal incentives. The resulting bias toward investment means that counteracting stabilization policies is warranted as a second-best solution to making private investors bear the full costs--and risks--of their investment decisions.

Even if private investment projects were carrying all of their own costs, the Government's own five-year investment plan looks very ambitious in the current economic environment. When it is also considered how vulnerable the government finances are to any downturn in the tourism market, the authorities must surely be looking to cover a large part of the investment program through further fiscal savings.

If sufficient current surpluses cannot be generated, then the investment program should be curtailed further, in order to avoid the prospect of an increasing debt-service burden at a time when general revenues may be retrenching.

I therefore strongly support the intention of the Aruban authorities to build up a current fiscal surplus position, and hope that this will be supported by the removal of remaining investment subsidies. I would also encourage considerable caution with respect to the five-year investment plan.

The staff report points out that, in order to further stabilize domestic demand and inflation pressures, the Government can take actions to remove disincentives to private savings. In particular, it is suggested that capital markets be liberalized and that trade and capital flows be freed up further.

If interest rates and banking sector investment restrictions were liberalized, then interest-sensitive capital flows would tend to offset the strong monetary stimulus arising from direct investment flows, thereby raising domestic interest rates and helping to restrain domestic inflationary pressures.

In the absence of such stabilizing capital market behavior, a greater adjustment role will be played by domestic price and wage levels. This is to say, rather than expenditure reduction, domestic costs will rise, causing a loss of competitiveness and a subsequent decline in tourism receipts.

There is nothing inherently wrong with this adjustment mechanism, but it is likely to be slow moving, and may be very difficult to reverse in a scenario in which excess tourism capacity is rising fast, and an improvement in competitiveness is needed quickly.

But again, the best way to avoid an excessive boom, which may turn into bust, is to remove destabilizing fiscal incentives and to allow financial markets to neutralize the expansionary liquidity effects of direct investment inflows.

The Aruban authorities have overseen a very successful phase of economic development. I agree with the staff, however, that they are now at a crossroads, and must make very careful policy choices if they are to ensure that their good work of recent years is not undone.

The staff representative from the European Department stated that under the current circumstances of an overheating economy in Aruba, there was no scope for seeking actively a further diversification of the economy. Indeed, diversification might have to be abandoned into the medium term, because of the likely shortage of resources over that period. For the longer term, as Mr. Spencer had pointed out, the return from new ventures would have to be such as to justify both private sector investment and the public sector investment that would be needed to support it.

The staff had had considerable reservations about reopening the oil refinery at the current stage, especially as the resource situation--including the labor market--was already very tight, the staff representative remarked. Even over the longer term, the operations of the refinery were unlikely to lead to a more stable labor market, and the staff believed that the present was an especially inopportune time to redirect already scarce labor resources to another sector of the economy. Moreover, the agreement with the oil company for reopening the refinery allowed the company a ten-year tax holiday, so the government would not realize any immediate fiscal revenue from it. Accordingly, the arrangement did not appear to have the potential for generating much in terms of return for the country over the forthcoming decade.

One speaker had wondered what could be done in order to control the expansion of monetary aggregates without recourse to credit controls, the staff representative recalled. The authorities in their financial management maintained a restriction on the net foreign asset position of banks. The staff believed that such a restriction tended to bottle up available financial resources in the country, and thus made it difficult to control the development of monetary aggregates and credit without seeking recourse to credit controls. Interest rate policy was not easy to implement in such an environment as well, as the banks had no alternative to seeking as high a return in the domestic market as possible, and thereby moving into types of lending that did not represent an effective allocation of resources. It would in fact be possible to invest a good part of the savings surplus abroad--at least temporarily--to lift the restriction, and the staff had raised that point with the authorities. However, the authorities were afraid that such a step would have an effect on the official reserves position, and could undermine exchange rate stability.

The restriction on the net foreign asset position of the banks also had ramifications for bank competition, the staff representative pointed out. As there were insufficient outlets for banks' deposits, there was not much competition for deposits. That was another reason why the authorities might consider modifying the restriction on net foreign asset holdings. Stimulating the development of short- and long-term capital markets in Aruba might also encourage more competitive behavior among banks for the types of financial assets that were not currently available in the country.

One speaker had expressed some sympathy for the somewhat restrictive position of the authorities with regard to immigration, for social reasons, with which the staff also had some sympathy, the staff representative observed. That notwithstanding, the staff wondered whether the benefits of sensitivity to social concerns might not be outweighed by the losses in Aruba's competitiveness that could result from the tight labor market situation and the attendant rise in wage costs. A more liberal immigration policy would be likely to exercise a downward effect on wages and would raise the possibility of avoiding a wage-price spiral. If Aruba's competitiveness were to deteriorate, it would ultimately be very difficult even to maintain sufficient employment for the local population, especially in the tourism sector, where the effects of a deterioration in competitiveness would be felt the fastest, and would last the longest. In that connection, the staff had proposed that the authorities phase in quickly immigration permits of limited duration, so as to meet the current demand for labor while obviating the social problems of increased immigration over the longer term.

The government guarantees to the hotels that had been referred to in the staff report were to end in 1999, the staff representative related. Very little could be done to change the terms of the guarantees, unless the hotels were willing to renegotiate them, which was unlikely. The authorities were however trying to use the leverage they had over those hotels that were seeking to add to existing guarantees because of cost overruns, for example, by insisting that a new clause be placed in the contract that raised the incentive for hotels to be commercially successful--which, unfortunately, was not the case in current guarantee agreements.

One speaker had expressed some doubts about whether a wage pact could be successful in a small economy like that of Aruba, the staff representative recalled. The wage pact in Aruba involved the employers, the Government, and the unions. However, with respect to the employers, there was admittedly no guarantee that the future owners of the hotels would be committed to the wage pact, especially if their financial situation deteriorated. Nevertheless, those concerns should not dissuade the authorities from seeking such a pact.

The Government, for its part, could clearly make a commitment with respect to a rearrangement of taxes, lower direct taxes, a reduction in the progressivity of direct taxes, and active support for an expansion of social coverage, which would help to reinforce any wage pact, the staff representative from the European Department concluded. Such steps had been discussed in the report of the Fund on a possible reform of the tax system. The Government had already expressed its intention to widen the social coverage. The initial indications were that the unions were prepared to consider their wage demands in the light of an improvement in secondary benefits.

Mrs. Hansen made the following statement:

> The small island economy of Aruba presents some interesting issues, which the staff has aptly described in an interesting and well-written set of documents. We are in broad agreement with the staff's analysis. The problems which Aruba faces today are the consequences of its success in establishing a booming tourist industry. Nevertheless, it is important to correct the problem of overheating and ease the extremely tight conditions in the labor market promptly, before they undermine the foundations of growth and financial stability.
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> In this connection, there have been some encouraging developments in the fiscal area, such as the declining size of the government budget deficit, and the decision to establish a contingency fund to meet possible calls on government guarantees. However, we agree with the staff's assessment that fiscal policy

has not been as tight as would be desirable in the current situation of a rapidly overheating economy.

A number of possible actions on the expenditure side could both improve the fiscal balance and ease labor market conditions. With the wage bill representing about half of current expenditure, and evidence of overmanning in the civil service and the public sector enterprises, maintaining the government hiring freeze and reducing employment levels in the government and public sector enterprises seem in order. Reducing employment in certain public sector enterprises may also permit a further reduction in government subsidies to these enterprises.

Although we recognize the importance of basic infrastructure to support the tourist industry, perhaps there is also more scope to streamline the size of the public investment program, thereby easing the government's financing requirements and the demands of the construction sector on the labor market. In this connection, we support the decision to cut back on public housing investment. I would be interested to know, however, what kind of incentives will be offered to the private sector to provide more housing, and what kind of fiscal impact these will have. In our view, a well-designed property tax and frequent adjustments in property assessments to reflect market values, as recommended by the Fund technical assistance team, could help spur private sector housing.

Given the cyclical nature of tourism--upon which Aruba depends so heavily--it would be desirable to run fiscal surpluses in the good years as a hedge against inevitable downturns. However, this is hardly possible, given the failure of the current tax system to capture the revenues of the tourist sector during its boom years, as seen in the shrinking tax base of recent years. Thus, we would strongly urge the authorities to act upon the recommendations of the Fund technical assistance report, which we believe would help broaden the tax base and improve compliance.

We also agree with the staff on the need to allow additional labor to migrate to Aruba. The extremely tight conditions in the labor market, which are driving up wage costs and contributing to inflation, will have serious negative effects on the economy if they are allowed to persist. In the short term, the unavailability of low-cost labor in the tourist sector will adversely affect both the cost and quality of hotel services, and, ultimately, Aruba's ability to compete as a tourist center. Insofar as hotel profitability is affected, further calls can be expected on the government guarantees of the sector's external debt. At the same time, an acceleration of domestic prices will tend to hamper the Government's efforts to attract other industries to the island, and stifle economic diversification.

The staff has made a number of constructive suggestions about ways to increase the availability of labor, either by shedding labor from less productive uses in government and the public sector enterprises, or by permitting more immigration. While we understand the sensitivities about potential social strains associated with the latter approach, the potential strains of high inflation and a flagging tourist industry should not be underestimated either. A 5 percent vacancy rate only amounts to some 1,400 unfilled jobs. While this may be a substantial number for Aruba, it is still a rather small number in absolute terms, and an amount which it should be possible to absorb.

In fact, one cannot help wondering whether the labor situation in Aruba might not provide opportunities for the Kingdom of the Netherlands as a whole. The Kingdom of the Netherlands is obviously a case of a highly segmented labor market: in one part of the Kingdom there is an acute labor shortage, while in most of the rest of the Kingdom there is high unemployment. It would seem advantageous to both parts of the Kingdom to reduce the structural rigidities which prevent greater labor mobility between the Kingdom of the Netherlands - Netherlands and the Kingdom of the Netherlands - Aruba.

One could, for example, envision a scheme whereby qualified members of the unemployed in the Kingdom of the Netherlands - Netherlands--say, recent university graduates unable to find employment elsewhere--were encouraged to spend a fixed period of time--two years, perhaps--working in sunny Aruba. As these individuals would be unlikely to stay permanently in Aruba, or to bring dependents who would place additional demands on the social infrastructure, the social frictions which the Aruban authorities associate with higher immigration might be minimized. At the same time, there would be some cost savings to the Kingdom of the Netherlands - Netherlands, even after subsidizing the airfare to Aruba, of allowing some of its unemployed to gain some work experience in Aruba, instead of unemployment insurance in the Netherlands.

Knowing of the boom and bust nature of tourism, we have some sympathy with Aruba's desire to diversify its economy. However, given conditions in the labor market and the overheating of the economy, we share the staff's view that this is not the moment to be offering costly fiscal incentives or to be putting additional pressures on wages and prices. In this connection, we would support the abolishment of tax holidays for new hotels and industry, and we wonder whether this was done as of January 1, 1991, as proposed.

I would appreciate some additional information from the staff on a few points mentioned in the background paper on recent economic developments. It is noted that price controls were introduced in September 1990 on basic necessities representing 10 percent of the consumer price basket. We consider price controls counterproductive, and I would appreciate any information the staff or Mr. Hogeweg may have on the authorities' intentions. The background paper also notes that government operations have been partially financed by a significant accumulation of arrears to domestic and foreign suppliers. It would also be helpful to know how the authorities in this area intend to reduce these arrears.

In conclusion, the Aruban authorities face a complicated task of balancing the need to support the tourism sector, while reining in expenditures and improving the fiscal balance.

Mr. Ishikura made the following statement:

We are in broad agreement with the staff's appraisal.

We can see very well from the staff paper that the character of Aruba's economy is one of uniqueness and vulnerability, as a result of the fact that it is a small island. Almost all of Aruba's main industries are oriented toward the rest of the world and are directly affected by the external environment. In the present situation, the authorities should pay particular attention to the effects of the recent oil price increase and the slowing of growth in the United States.

Regarding the recent economic developments in Aruba, as the staff report notes, it is imperative, although very difficult in terms of economic management, that the authorities cool down the overheated economy that has been caused by the excessive hotel construction boom, without impairing the profitability of private investment for tourism. In this situation, the shortage of labor has become very serious. It is necessary to streamline immigration procedures and to direct excess labor from the public to the private sector. At the same time, the authorities should be urged to strengthen the monitoring and review of labor markets to provide a reliable data base for planning measures against labor market imbalances.

The government guarantees for hotel investment are another serious issue to be tackled. It seems that almost the only way to solve this problem would be to set up a guarantee fund, while maintaining tight and prudent financial policies, in order to protect against an unsustainable fiscal burden that would result from a massive calling up of these guarantees in the future.

In the long run, the sources of income should be diversified, by building up a diversified portfolio of financial contingency reserves in particular, and efforts to increase the financial savings of both the public and the private sector should be maintained. The authorities should be encouraged to pursue efficiency in the financial sector, including the improvement of monetary policy measures, as the staff recommended, in order to provide an appropriate environment for financial activity.

Mr. Prader made the following statement:

Aruba presents us with a most interesting case of a small and open island economy which is--as are all economies in this category--vulnerable to negative external developments. In the absence of any automatic transfer mechanism which could equilibrate temporary income losses, as would be the case if Aruba were part of a larger and diversified economic area, the task of diversifying the economic structures of the country becomes imperative. There should, however, be no illusion: even if economic diversification is imperative, the diversification task cannot be accomplished in the short term. Even in the medium and long term, given Aruba's narrow capital base and limited human resource endowment, it may hardly ever be accomplished.

These more general considerations have been corroborated in the 1980s in Aruba's case. The 1985 closure of the Logo oil refinery was a heavy blow to the economy, which was further weakened by the quasi-disappearance of tourist receipts. Under those circumstances, it is entirely understandable and appropriate that a maximum effort was made in the second part of the 1980s to adjust and diversify the economy. With the benefit of hindsight, however, one is allowed to conclude that policy errors were committed at that time, as is illustrated by the substantial buildup of government guarantees to the private sector.

The strong domestic cost-reduction efforts made at that time, in terms of labor costs, in particular, and the intensification of attempts to diversify the economy away from the oil sector, have been extremely successful, as is clearly evidenced by the double digit real growth rates of the last several years; indeed, it is true to the point that one could even conclude that the authorities have been too successful. A quick glance at Aruba's present economic situation would indicate an urgent need for a stabilization effort in order to avoid a damaging overheating of the economy.

The policy challenges Aruba faces now are, however, somewhat more complex. The apparent need to cool down the economy and, hence, to follow a restrictive monetary policy, and to curtail public investment projects across the board or on a selective basis could very likely have detrimental effects on the profitability of past and current direct investments, in the hotel sector, in particular. The possibility is real, therefore, that such a move could trigger a direct recourse to public financing, as contingent liabilities in the form of extensive guarantees granted in the past would enter directly into the balance sheet of the budget. The task is further complicated by the authorities' reluctance to display a more forthcoming attitude in their immigration policy.

Under such circumstances, it might be helpful to consider the time horizon of the different tasks ahead. The diversification of the economy cannot be accomplished in the short term, but belongs more to the medium and long term. The cooling down of the economy is, however, rapidly becoming an urgent short-term task. Experience in Aruba and in other small economies shows that a diversification effort which relies heavily on foreign direct investment cannot be easily switched on and off. In Aruba's case, it has therefore to be continued, but clearly at a reduced pace for the time being. Also, investment projects which involve a call on public finances, even in a contingent liability form, have to be avoided. Priority has to be given to rather capital-intensive small investment projects, which would be implemented, preferably, once the bulk of the construction projects in the hotel and infrastructure sectors have been completed. The authorities should also seriously consider the staff's proposals for going in the direction of income diversification, as opposed to economic diversification. Given Aruba's extremely narrow resource base, the second will always remain a desirable, although illusory task, which reinforces the attractiveness of the former.

But the measures just mentioned will not render superfluous the short-term stabilization task, which will have to utilize all instruments of economic policy: restrictive monetary and credit policy combining a pragmatic blend of interest and credit ceiling variables, a cutback in the current fiscal account in order to make room for identified priority public investments, and an incomes policy which incorporates the basic necessity of preserving external competitiveness.

Even if all these measures are taken, it is doubtful whether they will constitute a package of measures comprehensive and restrictive enough to solve the policy conflict in which the Aruban authorities now find themselves. To give but one example, I would mention the restrictive incomes policy to be applied in particular to the public sector, so as to convey the desirable announcement effect to the rest of the economy. The background paper on recent economic developments, in Appendix III, clearly shows that public sector employment has been reduced in absolute terms, and that public sector employment as a share of total employment has dropped by nearly 10 percent over three years. Under those circumstances, the maintenance of an operational, qualified, and effective public sector will hinder the imposition of a strict incomes policy at a time when labor market conditions are tight.

The discussion above shows that the resolution of the policy dilemma will have to include various measures combined with a more liberal attitude toward immigration. The indicators of labor shortage are illustrative in this context. Vacancy ratios, in the hotel and construction sectors in particular, have reached extremely high rates of 10 percent and 15 percent, respectively. One can even argue that the maintenance of profitability for past and present investments in the hotel sector requires an inflow of labor. Indeed, it is hard to see how the level of quality service expected by tourists can be satisfied with such high vacancy rates.

A last point concerns the staff's advocacy of more market orientation, a stronger role for price mechanisms, and a fostering of competition. That policy direction is not surprising, as it reflects the Fund's economic doctrine. I have, however, serious doubts as to whether, in a country of some 60,000 inhabitants, with a total labor force of some 29,000 people, it will ever be possible to reach the level of perfect competition advocated by economic textbooks. Hence, realism would suggest policy moves toward a pragmatic blend of rules, controls, and regulations protecting and strengthening competition.

These remarks should in no way diminish the excellent job done by the staff in the consultation, and especially in the annexes of the background paper on recent economic developments. This confirms that economic problems and policy prescription can be more easily identified in small than in large and diversified economies; but perhaps this last recognition is only an illusion.

The staff representative from the European Department stated that the government had already been approached by foreign entrepreneurs offering to establish additional housing facilities on Aruba, but had made the usual request for a government guarantee. Given the Government's desire to stimulate private housing development, however, it appeared likely that the guarantee would be extended, in order to ensure that the immigrating labor force could be housed appropriately.

On the question of immigration policy, the staff representative noted, citizens of the Netherlands would be eligible to vote on Aruba after three months on the island; that fact affected immigration considerations, and perhaps Mrs. Hansen's question might be taken in that context.

Price controls covered basic necessities, as defined by the Government, and extended to about 10 percent of the consumer price index, the staff representative went on. There was no intention of phasing them out, because the strongest push for wage increases still lay ahead, and the Government wished to use the mechanism of the price controls as a basis for containing wage demands. The staff tended to disagree with that philosophy.

He agreed with Mr. Prader on the limitations of competition in a small island economy like that of Aruba, the staff representative continued. There was always scope for collusion between individual participants in various markets. The staff was, however, advocating the streamlining of certain mechanisms so that some competition could take place in areas in which there had been no incentives to compete previously. The two best examples were the financial sector, where competition for deposits was hampered by the existing financial market arrangements, and the retail and wholesale trading sector, where price controls did not support the emergence of competition.

The arrears of the government were in large part to the pension system, where the government was obliged to make payments for future coverage of pension liabilities, and to local suppliers of goods and services, the staff representative from the European Department concluded. The amounts involved were relatively high in 1988 and 1989. It was difficult to assess the current situation because of the lack of reliable statistics, but it appeared that the arrears had been reduced to a level of about Af 15 million to Af 20 million in 1990. The lack of adequate statistics also made it difficult to assess with accuracy the government's overall fiscal position.

Mr. Hogeweg stated that he wished to thank his colleagues for their contributions. He would convey the gist of the important discussion that had just taken place to the Aruban authorities.

A relaxation of the restriction which limited the net foreign asset position of the commercial banks would tend to increase competitiveness in the financial sector and, as such would be highly beneficial, Mr. Hogeweg commented. It would be easier to accomplish at a time when there was no perceived pressure on official reserves--which there was at the current juncture, however. It also illustrated the fact that once a regulation of that sort was in place, the whole financial system tended to adjust to its existence, and, consequently, relaxing or disposing of it became more difficult.

In many respects, individuals from the Netherlands itself might be ideal candidates for employment vacancies in Aruba, Mr. Hogeweg concluded.

It should be kept in mind, however, that the various parts of the Kingdom had autonomy in many aspects of their policies. Even apart from the voting issue that had been mentioned by the staff representative from the European Department, many of the sensitivities in Aruba that were attached to the importation of foreign labor applied as well to the importation of labor from other parts of the Kingdom.

The Chairman made the following summing up:

Executive Directors felt that the economy of Aruba had staged a remarkable recovery from the external shocks in the mid-1980s. That recovery had in good measure been the result of the decisive economic policies of the authorities. The new investment boom in the tourism sector had been noteworthy, but it involved considerable risks, not only for the maintenance of competitiveness, but also in the event that government guarantees in that sector would be called upon, which would endanger the public finances for years to come.

Given the strong upcoming demand for labor at a time when any leeway in the domestic labor market was virtually exhausted, an easing of immigration policies commended itself if a further acceleration of the wage-price spiral was to be prevented, and the competitiveness of the crucial tourism sector preserved; a few speakers, however, said that the social risks of large-scale immigration should be borne in mind. All opportunities to mobilize the domestic labor supply had to be explored. At the same time, measures aimed at deflecting current wage pressures, such as a medium-term wage pact which could include an improvement of nonwage benefits, should be considered.

Directors also believed that an expansion of economic and social infrastructure was needed to support the growth of tourism. That would require substantial financial resources and put further strain on existing physical resources. To contain the emergence of large financial disequilibria and a worsening of the problem of overheating, it was necessary to strengthen public and private sector saving. Financial policies needed to be extremely tight. Fiscal policy had to concentrate on removing destabilizing fiscal incentives and curtailing the growth of expenditure in nonpriority areas, while monetary policy had to emphasize tight credit, stronger competition among financial institutions, and a more active use of interest rates.

Directors also felt that a tax reform that placed greater reliance on indirect taxes could strengthen saving and work incentives, and that reduced reliance on direct taxes could help to ease the pressure on wages. They regretted the introduction of price controls, and advocated instead a strengthening of measures to foster competition.

It was expected that the next Article IV consultation with Aruba would be held on the 24-month cycle.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/91/4 (1/9/91) and EBM/91/5 (1/11/91).

5. ARAB REPUBLIC OF EGYPT - TECHNICAL ASSISTANCE

In response to a request from the Egyptian authorities for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/91/5 (1/7/91).

Adopted January 10, 1991

APPROVED: September 26, 1991

LEO VAN HOUTVEN
Secretary