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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/114

4:00 p.m., September, 9, 1992

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	S. E. Al-Huseini, Temporary
	T. P. Thomas, Temporary
	Deng H., Temporary
	G. Lindsay-Nanton, Temporary
	J. M. Abbott, Temporary
J. de Groote	
E. A. Evans	G. J. Matthews, Temporary
	B. Bossone, Temporary
	O. A. Himani, Temporary
	E. H. Pedersen, Temporary
H. Fukui	
	S. von Stenglin, Temporary
	T. Sirivedhin
A. Kafka	
	P. Bonzom, Temporary
	H. Golriz, Temporary
	J. A. K. Munthali, Temporary
	J. Dorrington
	Z. Trbojevic
	A. R. Ismael, Temporary
	M. Galán, Temporary
A. Végh	

J. W. Lang, Acting Secretary
M. J. Miller, Assistant

Also Present

IBRD: J. B. Sokol, Latin America and the Caribbean Regional Office. Policy Development and Review Department: J. P. Pujol. Southeast Asia and Pacific Department: A. B. Adarkar. Western Hemisphere Department: S. T. Beza, Counsellor and Director; C. M. Loser, Deputy Director; S. Bayas, R. A. Elson, J. Fajgenbaum, C. H. Fisher, J. S. Lizondo, G. G. Raymond, S. P. Tokarick. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: C. D. Cuong, B. Szombati. Assistants to Executive Directors: D. A. Barr, G. Bindley-Taylor, M. E. Hansen, T. Kanada, L. J. Morelli, F. Moss, P. Salles, F. A. Sorokos.

1. TRINIDAD AND TOBAGO - 1992 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1992 Article IV consultation with Trinidad and Tobago (SM/92/153, 8/6/92; and Cor. 1, 8/25/92). They also had before them a statistical annex (SM/92/160, 8/12/92).

Mr. Kafka made the following statement:

The authorities would like to thank the staff for its cooperation and support during the recent Article IV consultation. Trinidad and Tobago has pursued comprehensive adjustment measures which have, since 1990, succeeded in bringing about positive economic growth with modest inflation. The key areas of adjustment have been an early exchange rate adjustment, restraint in public sector expenditure, structural reforms in the area of taxation, divestment of state enterprises, and trade reform. The effort of the authorities was supported first by a drawdown under the compensatory and contingency financing facility in 1988, followed by two stand-by arrangements in 1989 and 1990, respectively.

During the period 1988-90, and in response to the adjustment efforts, the overall public sector borrowing requirement fell from 6.7 percent of GDP in 1988 to 1.4 percent in 1990, national savings increased, the external current account moved from a deficit of 3.3 percent of GDP to a surplus of 8.7 percent in 1990, and gross international reserves at end-1990 were four times their 1988 level.

After seven consecutive years of declining economic activity, Trinidad and Tobago experienced marginal real growth of 0.5 percent in 1990 and a more robust real growth rate of 2.7 percent in 1991. The recovery was driven by domestic consumption and a buildup of inventories. Unfortunately, accommodating monetary policies in the first half of 1991 contributed to increased demand, a re-emergence of a small external current account deficit, some capital flight, and a fall in net international reserves.

In response to the slippages experienced in the monetary sector in the first half of the year, the authorities strengthened the fiscal adjustment effort, and this, together with better than forecast oil revenue, lowered the overall public sector deficit to less than 1 percent of GDP, as opposed to the original targeted 3.5 percent.

In the second half of the year, the Central Bank responded to the developments in domestic credit expansion and reserve losses in the external sector by sharply increasing the statutory cash reserve requirements for commercial banks, while the rediscount rate was raised substantially in stages, from 9.5 percent to 11.5 percent by December 1991.

The inflation rate fell from 11 percent in 1990 to 3.8 percent in 1991, despite a rapid monetary expansion. It must be remembered, however, that the 1990 rate was affected by the introduction of a 15 percent value-added tax. The level of unemployment also fell in 1991, but remained unacceptably high at 18.5 percent.

It was clear that, in 1992, real growth would have to slow down given the external position at the end of the previous year. Yet, the new authorities, who assumed power in December 1991, felt that a strong monetary policy, together with fiscal prudence, would sustain the growth path at levels slightly below those of 1991, but with a substantial decline in inflation. In order to maintain fiscal discipline, the new authorities decided to restrain employment in the public service, exercise firm expenditure management, and not pay in full the Industrial Court award; however, in 1992, the Government dealt with the recurrent obligations under that award.

As a result, the overall fiscal deficit for 1992 was limited to 1.5 percent of GDP. The overall public sector deficit, however, was expected to widen to approximately 3 percent of GDP, reflecting the large energy sector investment projects, all of which are financed by commercial or multilateral lenders.

In the monetary sector, tight policies will continue, and efforts will be made to ensure that the large Central Bank advances to commercial banks, to cover deficiencies in their legal reserves in 1991, will be reduced during 1992. In addition, steps were to be taken to accelerate the repayment of long-term loans provided to the restructured Workers' Bank.

In 1992, structural adjustments are expected to continue. The most important--the removal of all remaining quantitative restrictions, replacing them with tariffs--was completed on June 30, 1992. In addition, the authorities intend to lay before Parliament legislation to modify or change the oil taxation regime, the Foreign Investment Law, and laws relating to strengthening the supervisory and regulatory framework of the financial system. With respect to state enterprises, the authorities entered into negotiations for the sale of its 51 percent share in Fertin--the state-owned ammonia company--and a total divestment of Government holdings in the urea company. In addition, they will divest, in the near future, state holdings in firms in methanol, cement and steel production, printing and packaging, and fishing. In the petroleum sector, the two major state companies will be merged, and the new firm partially divested.

No sooner had the authorities defined their economic policies in the presentation of the 1992 budget than the international reserves came under severe pressure, as the private sector responded to rumors regarding the floating of the exchange rate and suspicions about the accuracy of the Government's $19 a barrel oil price projection in fiscal year 1992. This resulted in capital flight and substantial prepayment of foreign liabilities. To protect the external position, the Central Bank demanded an early repayment of outstanding advances from commercial banks and raised the rediscount rate to 13 percent in January. The result was a substantial tightening of liquidity in the banking system, a slowdown of credit to the private sector, and the highest level of real interest rates in the economy in 10 years. The expected slowdown in economic activity has led to a downward revision of real GDP growth to 0.3 percent in 1992.

On the fiscal side, in the first six months of 1992, realized petroleum prices proved better than originally projected; however, there was a substantial underperformance of nonpetroleum tax revenue, especially with respect to the value-added tax and some of the new excise duties introduced in the 1992 budget. In response, the authorities have quickly adjusted expenditures across a wide spectrum of items, which has resulted in a downward revision of the 1992 fiscal deficit. In addition, the authorities sought the technical advice of a consultant from the Fiscal Affairs Department, who provided valuable assistance with respect to strengthening the value-added tax administration.

The continued application of strong monetary policy is expected to prevent any further slippage in the level of net international reserves, to contain excessive growth in credit to the private and public sectors, and to keep inflationary pressures under control. Through August 1992, the net international reserves of the Central Bank continued to strengthen, bringing the total improvement since March 1992 to around $95.0 million.

As noted in the staff report, the authorities originally intended to introduce a new fiscal year beginning October 1, 1992. Draft legislation to change the fiscal year was brought before the Parliament on August 28, 1992; however, the authorities, confronted with a variety of suggested amendments to the draft legislation, resolved to maintain the fiscal year on a calendar year basis. The suggested amendments would have substantially undermined the authorities' ability to carry out prudent fiscal management by weakening their flexibility with respect to raising revenue and sourcing financing, while creating rigidities with respect to expenditure management.

Over the medium term, the rise in imports associated with the large energy projects will cause imports to rise faster than exports, resulting in a deterioration in the current account in 1992-1993. This, together with large repayments to the International Monetary Fund and other amortization payments, will result in relatively large financing gaps over the period 1992-94.

To meet these challenges, the authorities have developed a medium-term policy framework for the period 1992-95. The major thrust of that framework is to strengthen the overall fiscal position such that the fiscal deficit is eliminated in 1993 and some small fiscal surpluses are achieved over the medium term. To this end, emphasis will be placed on strengthening the system of value-added tax administration, broadening the tax base by reducing the current system of duty exemptions on certain imports, and proceeding with the adjustment of the manpower resources of the civil service. In addition, the authorities propose to reorganize the administration of customs, revise the system of property taxation, and--in 1993--they intend to establish a revenue protection agency. Fiscal strengthening is to be complemented by improvement in the finances of the state enterprise sector, particularly in the energy sector, but also in the public utilities. The strengthening in the overall public sector accounts, combined with prudent monetary policies, is expected to improve the country's gross reserve position from 2.6 months of imports in 1992 to 4 months of imports by 1995. To support the growth process, the improvement in domestic savings will be reflected in higher investment to GDP ratios, which are expected to grow from 16.6 percent in 1991 to an average 23 percent over 1992-95.

To support the necessary improvements in the ratio of investment to GDP, the authorities have sought significant long-term finance from the Inter-American Development Bank (IDB) and to a lesser extent, the World Bank over the medium term. In addition, the authorities are proceeding vigorously with a divestment program, particularly with some of the currently viable energy enterprises, the proceeds of which will be used to reduce current external liabilities. To help close the financial gaps for 1992-94, the authorities have decided to reenter the market for commercial borrowing. To this end, they are seeking to place a five-year note for $100 million on the Eurobond market in the last quarter of 1992, and also to place bonds to the value of an additional $100 million and $50 million in 1993 and 1994, respectively.

It is evident that fluctuations in international interest rates and petroleum prices can have a substantial impact on the country's medium-term outlook. Both are clearly exogenous variables over which the authorities have little influence. Nevertheless, they will seek to explore various hedging arrangements in respect to both oil prices and interest rates, so as to lower their vulnerability to sudden future changes.

The authorities are convinced of the correctness of their economic thrust and intend to do their utmost to attain the medium-term objectives they have set for themselves. Moreover, they have always welcomed and valued the advice of the Fund in both the formulation and implementation of their economic programs, and look forward to maintaining the good close relations with this institution, as Trinidad and Tobago continues to design its economic programs to meet the goal of sustainable economic growth.

Mr. Dorrington made the following statement:

I know that the Chairman and everyone else around this table has the Fund's Articles of Agreement inscribed on their hearts, but as a new boy participating in my first Article IV consultation discussion, I had to look up the Fund's surveillance remit. In Section 3(b) of Article IV, I read that "[t]he Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies."

While on a broad interpretation one might say that the whole report meets this remit, it is surprising that so little space is given to exchange rate policy specifically. There is, however, a tantalizing comment at the foot of page 15, that "[t]he authorities said they would continue to keep the exchange rate system under review. They also noted their interest in considering a possible shift to a more flexible arrangement at some later date." I presume that the staff concludes that, at least for the time being, the current policy remains appropriate, and I would not quarrel with that, but some analysis of this issue would have been useful. Mr. Kafka's statement gives some useful background on this, but perhaps the staff could elaborate a little more.

More generally, the authorities in Trinidad and Tobago deserve considerable credit for their substantial achievements since the adoption of a comprehensive adjustment strategy in 1988, particularly with regard to the liberalization of markets and the improvements in the current account and the central government deficit. As a consequence, the steady decline in growth witnessed during the 1980s has been halted, and the environment is now much more conducive to productive private investment.

Although major advances have been made in the fiscal position, the prospects for both the immediate future and the medium term seem to be subject to a number of uncertainties. I will list six separate, but related, causes for concern.

First, the projections for 1992 have deteriorated, and it is not clear that all the reasons for the revenue shortfall this year listed on pages 8 and 9 will be absent next year. In particular, while good administration is obviously essential, it is far easier to say than to achieve.

Second, there is the unresolved issue of back pay ordered by the decision of the Industrial Court. It was not clear from reading the paper how this is to be resolved over the medium term. However, Mr. Kafka's statement says that "[i]n 1992, the Government dealt with the recurrent obligations of that award," so perhaps it is resolved after all. Perhaps Mr. Kafka could enlighten us further on that.

Third, over recent years, the non-central government public sector deficit has worsened. It is noticeable from the comprehensive statistical appendix that five of the six major public utilities listed in Table 25, and half of the key public enterprises listed in Table 26, made losses in 1991.

Fourth, revenue from oil taxes is uncertain, both because oil prices are inherently uncertain, and because it is not clear to what extent the tax regime will have to become more favorable so as to encourage further development of oil production.

Fifth, to the extent that prospective improvements in the fiscal position result from new taxes on imports, this is a source of revenue that for other reasons it is hoped will turn out to be temporary.

Sixth, and last, as for all countries with dollar-denominated floating rate debt, there is the risk of a rise in U.S. interest rates over the medium term. As a matter of fact, I would be interested to know whether the staff and the authorities of Trinidad and Tobago, when making their projections, assume rises in short-term Eurodollar rates in line with, over the months and years, the current upward sloping yield curve.

The balance of the risks seems to be strongly adverse. The risks are there, of course, but none of them may materialize. Indeed, some of them may materialize in an optimistic direction, but they do cast doubt on whether we will see the improvement in the fiscal deficit of 1.5 percent of GDP called for in 1993, and suggest that a sequence of further measures will be required to assure medium-term sustainability, particularly in view of the medium-term prospects for oil revenue. I would be grateful for comments on these risks from either the staff or from Mr. Kafka.

Major structural reforms are urgently needed to improve the efficiency of the public sector corporations and to speed up the pace of divestment. I understand that the authorities are now examining options with the help of the World Bank. Lower investment in this sector has been one of the unfortunate repercussions of fiscal rationalization, but divestment might give these industries a welcome injection of new capital. Privatization would also provide a helpful, albeit temporary, boost to fiscal revenues and, to the extent that foreign investment could be secured, would reduce the external financing gap, and thus keep down the level of overall debt. Further tariff increases should also be considered to mitigate the major drain on fiscal revenues from central government transfers to the utilities.

While on structural issues, I certainly agree that the financial sector appears weak and that the lack of effective competition--in particular, the lack of international banking--is giving rise to the still uncomfortably large spread between lending and deposit rates. Measures to improve competition and supervision will help. In this regard, I welcome the measures taken by the Central Bank to improve supervision to avoid repetition of the sort of problems encountered with the Workers' Bank.

Given the vulnerable financing position projected over the next few years, it is clearly important to avoid a repetition of the decline in reserves seen in 1991. Credit growth will need to be closely monitored, accompanied by appropriate monetary tightening if credit growth is too buoyant. But this will be ineffective unless the Central Bank strengthens its ability to engineer interest rate changes by ensuring that legal reserve requirements are more strictly enforced. I find the existing practice of providing some temporary advances at well below minimum lending rates quite inexplicable, and I would be interested to know what is actually being done about that.

More generally, I very much applaud the efforts being made to open up the economy. The abolition of the negative list of imports is a very positive step, but the balance of payments position seems to point to downside risks. On the one hand, exports are optimistically projected to rise by 7.5 percent per annum over the next five years, and excluding petroleum and chemicals, the figure is even higher, at 8.7 percent. On the other hand, imports are forecast to grow by only 1.3 percent per year, but to be fair, this is in part due to a dramatic reduction in imports related to energy products, with other imports growing by 5.3 percent per annum. If this implies a corresponding cutback in exploration and further developments of energy-related facilities, however, it raises even greater concerns in the medium term.

It is encouraging to see that Trinidad and Tobago has access to foreign capital markets. In this regard, I wonder whether we could be confident that the planned $100 million placement in the

Eurobond markets will go smoothly. Nevertheless, I note from Mr. Kafka's statement the plans for further issues, and I would urge the need for caution in extending the amount of foreign debt, given the still significant debt ratios. This is perhaps particularly true for floating rate instruments. However, I am encouraged that the authorities are exploring the possibilities of hedging some of the risks.

In conclusion, the authorities of Trinidad and Tobago have come a long way, and for that they deserve praise. But they are not over the top of the hill yet, and there may be some unpleasant obstacles in the way. It would be prudent to prepare for them.

Ms. Lindsay-Nanton made the following statement:

The firmness with which the authorities of Trinidad and Tobago implemented their adjustment program during the 1988-90 period was apparent, in that the fiscal situation improved, net international reserves increased significantly, and inflation subsided somewhat.

Unfortunately, however, in 1991, notwithstanding a restrained fiscal stance, an accommodating monetary policy, as evidenced by substantial growth in credit to the private sector, led to a marked drop in net international reserves--by some $155 million.

A number of measures, albeit delayed, were adopted by the authorities to stem the outflow of foreign exchange during the latter part of 1991. However, the level of net international reserves continued to decline during the first two months of 1992, as a result of injudicious public pronouncements on the merits and demerits regarding the floating of the exchange rate.

While it appears now that the decline in net international reserves has been stemmed, the situation continues to remain tenuous given the weakness in government revenue collections thus far. In view of this, it would seem that close monitoring of the fiscal and monetary situation is essential if further policy slippages are not to take place.

Since I am in broad agreement with the staff report, I shall comment only on a few aspects of the authorities' 1992 economic program.

Regarding fiscal policy, the staff notes that central government revenues as a proportion of GDP in 1992 are expected to be some 1.3 percentage points below the 1991 level. This is so notwithstanding the effects of the tax package, which was expected to yield revenues of some 1.5 percent of GDP, as well as higher oil tax receipts. Furthermore, the staff comments that the authorities attribute this weak revenue performance to overestimation of tax measures and problems in administration of the value-added tax.

The authorities have taken some steps to address the weakness in the administration of the value-added tax, as evidenced by the request for Fund technical assistance, but I would be interested in knowing what is being done in view of the loss of specialized personnel. Likewise, I would want to know what efforts are being made to improve customs administration, as noted in the staff report.

While efforts to improve tax administration are appropriate, and the establishment of a revenue protection agency seems warranted, as Mr. Kafka has stated, it is unclear how this buoyancy of other taxes to which the staff refers is to be realized. The staff mentions one possible source--property taxes. In addition, the authorities believe that the elimination of exemptions for certain imports which would now be subject to a 5 percent tariff might offer scope for greater revenue. However, those potential sources of additional revenue could be offset by the substantial reduction in the maximum charge in the level of the Common External Tariff that is contemplated by the authorities. Indeed, the revenue picture is even more clouded when the new petroleum tax regime that is being contemplated is taken into account, and which is likely to lead to a loss of revenue of some 0.5 percent of GDP for 1992/93. Might the staff clarify or make more explicit the prospects for further revenue generation?

On a related point, the staff notes that over the next few years, "[t]he public sector will need to generate a significant domestic surplus if Trinidad and Tobago is to achieve a viable external position." Meanwhile, Mr. Kafka refers to the elimination of the fiscal deficit in 1992 and the generation of some small fiscal surpluses over the medium term. How are these two views reconciled?

The control of public expenditures will be critical if the authorities are to consolidate their fiscal position further. Like the authorities, I recognize the need to continue to trim the public sector labor force over the medium term. However, I have some sympathy with their reluctance in doing so in the near term, in view of the already high level of unemployment prevailing in the country.

This being the case, other ways and means of reducing expenditure become important. In this respect, a worrisome feature is the continuous high level of transfers and subsidies to public utilities and enterprises. Indeed, I welcome the authorities' intention to streamline their operations and implement a strategy for cost recovery in a number of these utilities. However, I would urge the early approval by the Public Utilities Commission of upward tariff revisions in utility rates, so as to reduce the dependence on central government finances. This would be essential if the still too high domestic borrowing requirement of the public sector is to be reduced and not pose a constraint to private sector credit and investment.

In the area of monetary policy, the authorities' efforts at tightening credit policy--after the inertia exhibited in 1991--appear to be working. However, we agree with the staff that credit policy could be strengthened further by charging rediscount rates to cover legal reserve deficiencies on the part of commercial banks--well above prevailing market rates. In addition, the early adoption of the proposed reforms of the central bank law, aimed at enhanced prudential standards and enforcement powers, should help strengthen the financial system further and improve private sector confidence.

The staff notes that the current account of the balance of payments as a proportion of GDP is expected to deteriorate in 1992 on account of a decline in oil exports and an expansion of energy-related imports. Nevertheless, this imbalance in the current account is to be covered by private and official capital inflows. However, the viability of financing the balance of payments over the medium term is a cause for concern, in view of the relatively large placements of Eurobonds that are required to help close financing gaps.

In addition, while the new export production associated with energy investment will contribute significantly to the balance of payments after 1993, Trinidad and Tobago's medium-term viability remains sensitive to oil price changes. I believe that the authorities' efforts at diversification of the economy are in the right direction. However, in view of the heavy debt repayments in the period 1992-1994, it remains imperative that the authorities continue to improve their fiscal position if the gross reserves position is not to be eroded.

Like Mr. Dorrington, I had a lot of concern regarding the area of exchange rate policy. The speculation that occurred against the Trinidad and Tobago dollar in the early part of 1992 was regrettable. Indeed, the situation highlights the importance of consistency in policy direction and strategy, which is imperative for macroeconomic stability. It is in this sense that I found the staff's advice--or lack of it--on exchange rate policy wanting.

The staff report states that for 1992, the authorities considered that Trinidad and Tobago had been able to maintain an adequate level of external competitiveness. However, the authorities expressed concern over the impact on the external current account of trade liberalization, and they have shown an interest in shifting to a more flexible arrangement at some later date.

In view of the still vulnerable economic situation in Trinidad and Tobago, I wonder what to infer from the sentence in the staff appraisal that "[t]o enhance an expansion in private sector investment, it is important that Trinidad and Tobago take further steps to reduce protection and maintain a competitive exchange rate." Specifically, what advice would the staff give regarding an appropriate exchange rate system?

Notwithstanding the progress made by the authorities in correcting some of the major domestic and external imbalances in the Trinidad and Tobago economy, the situation continues to remain fragile and worrisome. In this context, it is imperative that the authorities continue to monitor fiscal and monetary--as well as external sector--developments closely, and be ready to take prompt and swift action should the need arise.

Mr. Galán made the following statement:

The authorities of Trinidad and Tobago should be commended for the continuous progress that they have made over the last three years in addressing external and internal macroeconomic imbalances. Most of their success is the result of their firm commitment to adjustment and their willingness to undertake difficult measures. The Trinidad and Tobago economy is well prepared to deepen the structural reform process. Nonetheless, the authorities face the difficult challenge of establishing the conditions for sustained economic growth and diversification, while pursuing tight financial policies.

The authorities' commitment to adjustment is bearing fruit. In 1991, Trinidad and Tobago's economy performed well. Output grew, the inflation rate decreased, the exchange rate remained fairly stable, and the total stock of external debt at end-1991 was lower than at end-1990. Further progress in reducing the overall fiscal deficit has been made, and we are pleased with the authorities' commitment to sustain and strengthen these adjustment efforts, as indicated by Mr. Kafka.

The fiscal policy objectives are sound and commendable, although the public finance projections seem to indicate a worsening of the overall fiscal position for 1992. We would like to encourage the authorities to further advance the structural reforms in the fiscal sector. On the expenditure side, it is important that the authorities control and reduce the wage bill, while on the revenue side, additional steps should be taken to lower the high dependence on revenues from petroleum taxation. This is even more important in light of the revenue loss that is likely from the tax reform that is being considered to promote private investment in the energy sector. The progress made in privatizing public assets is a step in the right direction. In this regard, the authorities' intention to use divestment proceeds to reduce external public debt is a well-advised decision.

After a loosening of the monetary stance in the first half of 1991, the tightening of credit since mid-1991 has been successful. We concur with the staff recommendation to charge a special penalty rate for central bank advances to cover legal reserve deficiencies. We are pleased with the authorities' commitment to a market-determined interest rate; however, the large spread between lending and deposit rates is a source of concern. The strengthening of prudential supervision and the enhancement of competition in the financial sector, as has been already mentioned by Mr. Dorrington, will do well in this respect.

The complete removal of restrictions on current international transactions will improve efficiency and would be in the best interest of the economy of Trinidad and Tobago, and would further advance the opening up of the economy as a means of enhancing domestic productivity and external competitiveness. Notwithstanding the progress achieved, the external position remains vulnerable to external shocks. In this regard, we support the authorities' intention to pursue policies oriented toward a greater diversification of the economic structure.

Finally, we would like to encourage the authorities to persevere in the path of structural adjustment. We hope that the international community will respond promptly to the actions undertaken by Trinidad and Tobago and will participate actively in the much-needed process of economic growth.

Mr. Trbojevic made the following statement:

I am in broad agreement with the staff appraisal and recommendations. The moves by the authorities toward a restrained fiscal policy and tighter monetary policy is to be commended. However, it is evident from the staff report that the widening imbalances in 1992 and the external financing gaps that are expected in 1992-1994 will require that the authorities intensify further their fiscal consolidation efforts, and apply an even tighter and more responsive monetary policy. In this respect, the staff's suggestions--which appear, from Mr. Kafka's statement, to be espoused by the authorities--should be supported strongly.

Indeed, from the above suggestions, the need to resolve quickly tax administration problems, widen and deepen the non-oil revenue-related tax base, and terminate the access of commercial banks to temporary advances from the Central Bank at interest rates below the minimum commercial lending rates, are of essential importance for the authorities' medium-term adjustment program.

In relation to budget expenditure restraint, I note the decision of the Trinidad and Tobago authorities not to pay at this point in time the back pay awarded by the Industrial Court. Given the Government's budget constraints, this is appropriate, but one wonders whether a mere postponement which is implied by the decision does not expose the Government to the danger of being forced to pay the full amount at one time, perhaps at a time of even tighter budget constraints in the near future. To avoid this possibility, the Government might consider negotiating with the employees an arrangement, with the backing of Government bonds issued to the beneficiaries, under which the back pay would be phased in over a certain period of time, so as to reduce gradually the burden on the Government of this obligation.

The improved position achieved with respect to ISCOTT--the iron and steel company--would seem to encourage the view that the authorities should consider seriously the possibility of speeding up the privatization process, which would lessen significantly the budget burden of the public enterprises. In the meantime, it is essential for the public utilities commission to be more flexible and responsive to the need for price and tariff adjustments.

Finally, the staff indicates that one of the reasons for the larger public sector deficit in 1992 is the sharp acceleration in enterprise investment related to the expansion of petroleum refining and petrochemical operations. Given that, in 1991, the country was only utilizing some 36.3 percent of installed refinery capacity, I wonder whether the staff could explain the reason for the need to expand capacity.

Mr. Matthews made the following statement:

After a long period of declining economic activity and the implementation of a comprehensive adjustment program, Trinidad and Tobago saw some of the results of past reform measures in 1990 and 1991: GDP growth resumed, inflation fell dramatically, the current account balance improved, and unemployment began to fall. The authorities are to be congratulated for the scope and depth of the reform measures that they have introduced, and it is encouraging to see that the new authorities appear to be committed to continuing with the reform process.

Notwithstanding the progress that has been made, monetary policy clearly went off track during 1991. The authorities appear to have responded adequately by raising the legal reserve requirements for banks and increasing the central bank rediscount rate later in 1991. However, this action did not occur until after the entire buildup of international reserves that occurred in 1990 had been lost. Further, this action was partly offset by another increase in advances to commercial banks.

Two primary causes of the growth in bank credit to the private sector and loss of international reserves are evident. First, the financial difficulties faced by the Workers' Bank raises the issue of the prudential supervision of the banking system. The steps taken to strengthen the Office of Bank Inspection are to be welcomed in this regard. Of potentially greater importance, however, is the apparent inadequacy of the legal reserve requirement. Commercial banks cannot be expected to meet reserve requirements if it is in their financial interest not to do so. As the regulations currently stand, temporary advances provided by the Central Bank to cover reserve deficiencies represent a source of loanable funds that are cheaper than funds bought on the market. I agree with staff that this practice should be discontinued, and that penalties for legal reserve deficiencies should be increased.

The second primary cause of the recent financial system instability appears to be related to speculative forces. This capital flight appears to have had little to do with economic fundamentals. Indeed, the relative stability of the real effective exchange rate over the last two years and recent growth of non-oil exports suggest that the fundamentals may be about right.

The tightening of monetary policy during the past 18 months, partly in response to these speculative forces, has resulted in a substantial increase in market interest rates and a considerable deceleration in the growth of monetary aggregates. With the progress that has been made in reducing inflation, minimum real lending rates were in the range of 9 percent to 13 1/2 percent as of mid-1992, depending on whether forecasts of consumer or producer price inflation are used as the measure of inflation expectations. The large spread between lending and deposit rates may explain in part these high real lending rates. However, I would be interested in hearing the staff's views on whether it thinks that monetary policy may be too tight for domestic conditions, and whether there may be some risk of a return to falling economic activity in 1992 and beyond as a result.

Regarding fiscal policy, the authorities have gone some way in removing the central government deficit, and have responded well to developments in financial markets. However, I would like to comment on the proposed changes to the taxation treatment of oil. Around one third of all central government revenue comes from the taxation of oil and related products. In the medium term, it would be desirable to reduce the reliance on this source of revenue. At the same time, future oil production may need further encouragement. Nevertheless, the weakness in government revenue performance observed so far in 1992, the need to implement the back pay component of the Industrial Court decision which has been outstanding since 1989, and the external financing gap projected over the medium term, all suggest that any decision that would reduce oil revenue in the short term should be delayed to coincide with revenue-enhancing measures that broaden the tax base.

The staff representative from the Western Hemisphere Department stated that he agreed with Mr. Dorrington about the key elements of monetary and fiscal management that needed to be monitored and addressed in the near term. On the question of tax policy, for example, steps were being taken to deal with the problem of administration of the value-added tax in the light of recommendations made by a member of the Fund's Panel of Fiscal Experts. In the near term, efforts were being made to allocate personnel within the tax office to deal with the shortage of qualified auditors. Efforts would then be made to increase the number of professional staff auditors in that office, to improve cross-checking with other revenue sources, and to intensify enforcement procedures to improve the performance of the tax.

The risk remained that the Government would have to award the back pay that had been decided by the Industrial Court, the staff representative agreed. The court's decision had dealt with the amount of wages and salaries due to civil service employees arising from the suspension of cost-of-living adjustment agreements in 1986. The recurrent obligation flowing from that decision--which had effectively reinstated those cost-of-living adjustments--had been dealt with, but the back pay award remained to be addressed. The authorities saw the issue as one of a real inability of the Government to pay, because of the huge size of the sums involved. There had been consideration of using some sort of bond scheme as a way of deferring payment, as Mr. Trbojevic had recommended, but it remained to be defined.

Regarding monetary policy, questions had been raised about the rediscount rate set by the Central Bank, the staff representative recalled. The authorities were examining closely using some sort of indicator for setting the rate. The Central Bank had basically set the rate in the light of demand by the commercial banks for rediscounts, and that technique had been successful in achieving a more balanced demand for rediscounts at least through the middle of 1992. Another possibility that was being considered to deal with rediscounts requested by banks in order to correct their reserve requirement deficiencies was a two-tier rate structure, under which any rediscount provided for that purpose would be authorized only at a high penalty rate.

Concerning the question of the stance of monetary policy at the present stage of the year, it seemed that monetary policy had been effective to date in reducing pressures on the Central Bank and in helping to restore its net foreign reserve deficiency, the staff representative continued. The statistics suggested that credit to the private sector had declined through the middle of the year, compared with what it had been at the end of the year, perhaps with some dampening effect on the pace of economic activity. The authorities were estimating real GDP growth for the year of something less than one half of one percent, compared with more robust growth expectations earlier in 1992. The thrust of the staff's advice regarding the mix of monetary and fiscal policy would be to maintain monetary tightness in order to see through the objective of restoring foreign reserves, and to adjust that in the light of the fiscal improvement that the staff and the authorities agreed was needed. There might then be room for relaxing the stance of monetary policy subsequently.

Regarding the consistency of the staff's advice on the overall fiscal position with what Mr. Kafka had suggested might be the authorities' views, the staff representative went on, while the staff did not have complete information about all of the judgments behind the authorities' statements on the fiscal position, it appeared that the authorities anticipated a somewhat slower pace of adjustment than had been recommended by the staff, especially regarding the generation, through the operations of the central government, of a domestic fiscal surplus in 1993 to support the needed improvement in net international reserves. In the authorities' view, the generation of a fiscal surplus could come from financing through Eurodollar bond placements, as well as from divestment revenues; in contrast, the staff had taken the view that divestment proceeds and Eurodollar bond financing should be seen as substitutes for one another. In that sense, the authorities' proposal would call for a somewhat larger amount of external financing than the staff's proposal. The staff would discuss that issue with the authorities at the time of the 1992 Annual Meeting in Washington. The interest rate assumption behind the Eurodollar borrowing had been drawn from the world economic outlook's estimates of the six-month London interbank offered (LIBOR) rate.

The staff report had intended to address the question of exchange rate policy in a broader context, and as a result and a reflection of domestic policies, the staff representative concluded. The staff had taken a broad view of the surveillance guidelines, by taking into account the full play of macroeconomic policies and how they were affecting the balance of payments. In its discussions with the authorities on exchange rate policy, the staff had made the following points. First, the choice of exchange rate regime--whether fixed or flexible--needed to be evaluated carefully in the case of Trinidad and Tobago, given the country's longstanding attachment to a fixed rate and the effect that changes in the exchange rate had on price and wage expectations. Second, the question of the exchange regime was subsidiary to that of the adequacy and strength of domestic policies, which was why the staff report had emphasized the issues of monetary and fiscal management. Finally, under a fixed rate regime, the authorities should be alert to the possible role of exchange rate adjustment as a complement to the ongoing tariff reform, but that would have to be evaluated in the light of the balance of payments developments and the actual pace of reform that was finally decided on.

Mr. de Groote commented that during a period of cooperation with the Fund under two Fund-supported programs, Trinidad and Tobago had experienced rehabilitation and growth, with a stabilization of inflation, a modest increase in real income, a successful renegotiation of its debt, and a restoration of spontaneous access to credit markets. The new Government had come to power with the new difficulties following the conclusion of the last Fund-supported program. He wondered whether the new Government might be urged to continue to rely on a Fund-supported program--under which they need not necessarily draw--in order to give to the public and the financial circles the certainty that correct policies would continue to be followed, as had been done in the case of Hungary in the period of change from one government to another.

There had been a rumor that there would be a change in the exchange system, which had resulted in speculative pressures against the Trinidad and Tobago dollar, Mr. de Groote recalled. He wondered what the nature of that rumor had been--whether it had been about a change in the rate between the U.S. dollar and the Trinidad and Tobago dollar, or about the abandonment of the system of pegging with the U.S. dollar. If it had been the former, he could understand the speculation, but it showed that the authorities had not been in a position to give enough certainty to the market. If it had been the latter, then the Fund had another example of the perverse effects of playing with the notion of floating exchange rates. The authorities should have attempted to explain to the public something that was quite obvious--that the exchange rate peg was entirely natural and appropriate, given that the country's exports were denominated chiefly in U.S. dollars. In either case, the authorities should have been capable of halting the speculation.

Reductions in average per capita income in Trinidad and Tobago had been accompanied by strong public offsetting measures, in terms of compensatory action in favor of the poorest segments of the population, Mr. de Groote noted. He hoped that the necessary rehabilitation of the public finances would not take place at the cost of that very useful extension of the safety net.

The staff representative from the Western Hemisphere Department replied that the staff had suggested to the authorities the notion of informal monitoring, either under the Article IV consultation or through informal staff visits. Regarding the speculation against the currency, the staff understood that it had been more in the nature of speculation of a shift to a floating regime, about which the Prime Minister had made some remarks in relation to future policy. The staff representative added that the authorities remained committed, in the context of fiscal adjustment, to the need for a social safety net.

Mr. Kafka stated that a negotiated solution to the problem of the back pay award of the Industrial Court might be hoped for. The perceived contradictions in the views of the fiscal situation as between his statements and those of the staff could be explained by the fact that the fiscal data that were presented had not included the divestment proceeds of public sector enterprises. Regarding the question of informal monitoring, the relations between the Fund and its member countries were so close that it could be said that those countries without formal monitoring arrangements had, in fact if not in law, informal ones, and the question was no longer really important.

Mr. Dorrington said that the veracity of Mr. Kafka's observation depended on the degree to which that observation was shared by politicians in all countries and by the financial markets, and in that sense, it might be doubted.

Mr. Kafka commented that an informal form of monitoring in which people believed would probably be more effective than a formal form of monitoring in which no one believed. He believed that credible informal monitoring could be very useful. In most countries there was great respect for the Fund's opinions.

Mr. de Groote observed that Trinidad and Tobago appeared to have an informal form of surveillance which neither the authorities nor the public believed in, and that therefore, it might have been better to have a formal form of surveillance, increasing the chances that the public and the Government would believe in it. The fact that there had been a major crisis on the exchange rate and on the reserves at the beginning of 1992 seemed to indicate that the authorities had not been in a position to convince opinion at home, despite the fact that they had been fully committed to a program at that time.

The Chairman made the following summing up:

> Executive Directors were in broad agreement with the thrust of the staff appraisal. Directors noted that Trinidad and Tobago had made significant progress in the period 1988-90 under programs supported by stand-by arrangements from the Fund in reducing financial imbalances and initiating structural reforms to diversify the economy and strengthen the basis for economic growth. Directors observed that inflation had come down and economic growth had accelerated in 1991, but that net international reserves had fallen sharply because of problems in credit control, leading to a surge in bank credit to the private sector.

Directors welcomed the commitment expressed by the Administration that took office at the end of 1991 to continue the broad thrust of the economic reforms that had been initiated in previous years to open the economy and to improve the framework for private investment. Economic management would be particularly demanding over the following few years as Trinidad and Tobago faced relatively large debt-repayment obligations. That situation called for the implementation of appropriate fiscal, credit, and wage policies and of structural reforms that would strengthen the balance of payments and enhance the prospects for economic growth.

Directors emphasized the critical role of fiscal policy in bringing about an improvement in domestic savings to support a strengthening of Trinidad and Tobago's net international reserve position and capital formation in the private sector. In that connection, Directors noted that, notwithstanding the reduction that had been achieved in the overall public sector deficit in recent years, the public sector's domestic borrowing requirement in 1992 was relatively high. Indeed, a shift to a domestic fiscal surplus would be required if the desired improvement in net international reserves was to be achieved. For that reason, many Directors stressed the importance of actions to improve the domestic tax effort--especially in view of recent problems in the administration of the value-added tax and the revenue loss envisaged under the reform of the oil tax regime--and to improve customs collection and the operating efficiency of state enterprises--especially the public utilities. A contraction in the size of the public sector, through divestment and reductions in public sector employment, was also required, but the importance of maintaining an appropriate social safety net should not be lost sight of.

Directors welcomed the steps that were being taken to strengthen the financial system and to improve the control of the Central Bank of Trinidad and Tobago over bank credit expansion, especially in view of the problems that had occurred in 1991. In addition to strict enforcement of legal reserve requirements and tighter control over the use of rediscounts by the banks, Directors considered that efforts should be made to expand the market for short-term government paper to facilitate the development of open market operations by the Central Bank. Such efforts would also help broaden the scope of competitive forces in the financial system that would serve to reduce interest rate spreads. In that connection, Directors underscored the importance of proposals under consideration to improve bank supervision and regulation, and to strengthen the prudential standards of financial institutions.

Directors noted the significant steps that had been taken by Trinidad and Tobago to eliminate exchange restrictions and reduce restrictions on trade, which could be expected to promote efficient resource allocation and an expansion of trade-related activities. Directors urged the authorities to continue to lower tariff protection and impediments to foreign private investment, and stressed the importance of maintaining an adequate level of competitiveness.

Directors observed that Trinidad and Tobago's medium-term external prospects appeared to be favorable because of the expected effects of a number of important energy-related export projects of the private and public sectors currently under way. However, in the period 1992-94, the country would face relatively large external financing gaps which the Government intended to fill by public bond placements or divestment. In that connection, Directors emphasized the importance of sound macroeconomic and structural policies to enable Trinidad and Tobago to regain access to voluntary market borrowing, while noting that borrowing would not be a lasting solution to Trinidad and Tobago's longer-term problems and needs.

It was expected that the next Article IV consultation with Trinidad and Tobago would be held on the standard 12-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/92/113 (9/4/92) and EBM/92/114 (9/9/92).

2. VIET NAM - SETTLEMENT OF OVERDUE FINANCIAL OBLIGATIONS IN SDR DEPARTMENT AND TERMINATION OF SUSPENSION OF RIGHT TO USE SDRS

The Fund decides that the suspension of the right of Viet Nam to use SDRs, as provided in Executive Board Decision No. 7855-(84/173) G/S/TR, adopted December 3, 1984, is terminated.

Decision No. 10125-(92/114) S, adopted
September 8, 1992

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 92/22 through 92/25 are approved.

APPROVED: April 12, 1993

LEO VAN HOUTVEN
Secretary