

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/131

3:00 p.m., October 30, 1992

M. Camdessus, Chairman

Executive Directors

M. Al-Jasser

C. S. Clark
T. C. Dawson

M. Finaish
I. Fridriksson

B. Goos
J. E. Ismael
A. Kafka

A. Mirakhor

D. Peretz

G. A. Posthumus
C. V. Santos
A. Torres

A. Végh

Alternate Executive Directors

A. A. Al-Tuwaijri
L. E. N. Fernando
Wei B.
G. C. Noonan
J. M. Abbott, Temporary
S. B. Creane, Temporary
J. Prader
R. L. Knight
G. J. Matthews, Temporary
J. Papadakis

J. A. Solheim
N. Tabata
B. Esdar
T. Sirivedhin
J. C. Jaramillo
G. Bindley-Taylor, Temporary
I. Martel
O. Kabbaj
H. Golriz, Temporary
L. J. Mwananshiku
J. Dorrington
D. A. Barr, Temporary
R. Thorne, Temporary
Z. Trbojevic
Y.-M. T. Koissy
R. Marino
E. Martínez-Alas, Temporary
A. G. Zoccali

L. Van Houtven, Secretary and Counsellor
K. S. Friedman, Assistant

1. Guinea - Enhanced Structural Adjustment Facility -
Review Under First Annual Arrangement; and Decision
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2. St. Vincent and the Grenadines - 1992 Article IV

Consultation Page 17

Also Present

IBRD: J. De Leede, Africa Regional Office. African Department: M. Touré, Counsellor and Director; P. Beaugrand, M. T. Hadjimichael, J. Ntamatungiro. Legal Department: J. M. Ogoola. Policy Development and Review Department: J. T. Boorman, Director; A. Basu, J. P. Pujol. Secretary's Department: J. W. Lang, Deputy Secretary; R. S. Franklin, B. R. Hughes, A. Jbili, A. Leipold, T. S. Walter, S. L. Yeager. Southeast Asia and Pacific Department: K. Saito, Director. Statistics Department: J. B. McLenaghan, Director. Western Hemisphere Department: S. T. Beza, Counsellor and Director; S. A. Coorey, J. Gold, O. Gronlie, C. I. Medeiros, R. M. Reichmann, S. Sheybani, S. J. Stephens, C. M. Towe. Personal Assistant to the Managing Director: R. Saunders. Advisors to Executive Directors: M. A. Ahmed, P. Bonzom, L. E. Breuer, M. B. Chatah, B. R. Fuleihan, J. Jamnik, Y.-H. Lee, M. Nakagawa, A. Raza, B. Szombati, N. Toé. Assistants to Executive Directors: S. Al-Huseini, T. Alami, M. C. Arraes, M. Blome, H. Dognin, K. M. Heinonen, O. A. Himani, T. Kanada, J. Mafararikwa, E. Quattrocioche, F. A. Sorokos, L. Tase, T. P. Thomas.

1. GUINEA - ENHANCED STRUCTURAL ADJUSTMENT FACILITY - REVIEW UNDER FIRST ANNUAL ARRANGEMENT; AND DECISION CONCLUDING 1992 ARTICLE XIV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/92/130, 10/30/92) their consideration of a staff paper on the midterm review under the first annual ESAF arrangement with Guinea and the 1992 Article XIV consultation with Guinea (EBS/92/161, 10/9/92).

Mr. Thorne made the following statement:

Let me start by expressing my interest in hearing Mr. Abbott's chair say monetary policy is aiming at too many economic targets and that it should concentrate on inflation control. I wonder if he would carry this approach over to other countries. Nonetheless, I share Mr. Abbott's concern at the slippages seen since the ESAF was put in place last year. In the circumstances, completion of the midterm review on time was clearly out of the question and a shadow program necessary.

When slippages occur in country programs, they are often blamed on exogenous shocks, when domestic policy shortfalls are just as much to blame. In this case, however, the "double whammy" of falling mineral prices and the collapse of trade with the former Soviet Union have inflicted a particularly sharp blow. The authorities' response, involving an acceleration in revenue-raising from other sectors, should leave the budget in a more robust position for the future, and so in this respect the need for further measures may have been a blessing in disguise.

All the same, it is disappointing to see from the staff's supplementary statement that the new revenue targets have already been missed, and that lower petroleum receipts are part of the reason. Given the heavy budgetary drain that this sector has been on the economy, the reported privatization of the petroleum distribution company this month was very welcome. But it will be crucial for government relations with the new company to be transparent and for revenue to be maintained. I wonder whether the staff could say who the new owners are and whether they are satisfied with the arrangements for the company's relationship with the government.

The scale of relations with the former Soviet Union has long been one of the major statistical uncertainties in Guinea. Only last year were these transactions first included in the full national accounts, and now they have had to be removed again given the institutional changes there. Nevertheless, Appendix 4 gives us some idea of the collapse of trade there with the loss of exports amounting to 1 1/2 percent of GDP. Could the staff say what effects they believe this collapse will have on the rest of

the economy and what actions the authorities could take to adjust for this extra problem, which goes beyond the shortfalls evident from the overall national accounts data.

This brings me on to my final and most important point. It is rather paradoxical that Guinea's program with the Fund, being an ESAF, is a medium-term one, but that the measures to correct financial imbalances are not yet very well defined beyond the end of 1992, which is only of course two months away. Like Mr. Esdar, I remarked a year ago on the very modest medium-term targets for reducing imbalances, and the lack of well-defined policy measures beyond mid-1992, and this seems to be one of the reasons why the authorities are able to keep the same targets for 1994 despite the slippages already. Given the authorities' extremely patchy past record, it is only with some trepidation that I support the proposed decision. We will expect to see much clearer measures, including especially on current expenditure control and timetabled structural reforms, together with strong adherence to the existing benchmarks for the rest of this year, if a second-year arrangement is to be contemplated.

Mr. Al-Jasser made the following statement:

Since 1985, the Guinean authorities have embarked on economic transformation programs aimed at establishing a market-oriented system. However, the implementation of this ambitious program has been spasmodic as the pace and direction of reform were often slowed or even reversed. This on-off record reinforces now the importance of reviving the momentum of the reform program and accelerating the implementation of corrective measures, in order to bring the program back on track. Consequently, I welcome the authorities' adoption of wide-ranging financial and structural reforms that promise to attain the overall program objectives. Nevertheless, sustained and continuous implementation of adjustment measures will be critically important for durable success to be achieved in this endeavor.

In addition to intensifying structural adjustment, it is necessary for the authorities to diversify Guinea's productive base, in order to reduce its vulnerability to exogenous shocks, especially the fluctuations in the global prices of bauxite and alumina. In this regard, the agricultural sector appears to possess significant potential. Also, it will be important to enhance the role of the private sector in the economy. Here, I note that the response of the private sector to the improved policy and institutional environment thus far has been slow, in part, due to the remaining structural constraints. However, the recent progress in land tenure and judicial reform and the setting

up of the Private Investment Promotion Office should help invigorate the private sector.

It is evident that an intensification of the reform effort is essential if Guinea is to successfully redress its macroeconomic imbalances over the medium term. In this regard, I am concerned by the marked and rapid increase in broad money during 1991. However, the recent tightening of the monetary policy stance and the intention to contain the growth of domestic credit expansion are steps in the right direction. In addition, the move toward positive real interest rates is encouraging.

This brings me to the linchpin of the adjustment strategy, namely, fiscal consolidation. I welcome the corrective measures that were undertaken recently to strengthen tax administration and to reduce public expenditure. These measures should help guard against future fiscal slippages and, thereby, help ensure that the program targets are attained. Nevertheless, I note from the staff report and from bilateral discussions with the staff that some 60 percent of the fiscal adjustment in 1992 is due to a 56 percent tax increase on petroleum products. Such a large selective increase on an essential input of production has significant adverse implications on private sector investment in critical sectors--such as agriculture and transportation--and, consequently, on economic growth and the efficient allocation of resources.

My concerns were intensified greatly when I learned that domestic retail prices of petroleum products are now well over 400 percent of international prices. Such a price level is hard to justify, even in the extreme, and clearly will have a detrimental effect on economic growth--be it in the industrial or transportation sector--and can also derail efforts to develop the potential of agriculture. I note that the staff regards such a high level of taxation as appropriate as it is lower than that in some European and CFA countries. However, I do not believe that the adoption of inappropriate policies by some countries justifies the promotion of such policies by Fund staff. While industrial countries may be able to absorb the excess burden and welfare losses associated with the excessive taxation of petroleum products, this is not the case for poorer developing countries. Indeed, in developing economies, such dramatic and excessive taxation could suffocate the development process itself. Furthermore, I note that the staff acknowledges that these exorbitant taxes on petroleum products are not proving to be very effective in raising revenues because of extensive tax evasion. Here, we have a case in which the staff is actively recommending policies that are damaging to any economy, particularly developing economies, and which, as the staff acknowledges, are not very

effective. I strongly believe that these policies are not in the best interest of Guinea and, therefore, I have grave reservations about supporting such policies.

While I do not oppose the conclusions of this review, because I do appreciate the efforts that the Guinean authorities are trying to make, I would like to emphasize that, unless a more credible fiscal consolidation package conducive to economic growth and development is adopted, including a correction of this ill-devised petroleum tax, I will find it very difficult to support a second annual ESAF arrangement.

With these remarks, I wish the authorities success in their adjustment efforts, and I hope they will also have better advice on how to promote fiscal consolidation with a good economic development policy.

Mr. Wei made the following statement:

We note with regret that the reinforced medium-term adjustment program launched by the authorities in mid-1991, supported by the ESAF, suffered setbacks late last year and during the first few months of 1992. Several quantitative and structural targets were missed due to exogenous shocks and policy slippages.

Such misfortune is not unique to Guinea, whose economy is in transition. However, what is important is the existence of a strong will and firm determination to arrest the slippages and bring the program back on track as soon as possible. It is therefore encouraging to note from the report and Mr. Santos's statement that the authorities have taken decisive actions to reverse this unfavorable trend. As a result, there has been a notable improvement in economic and financial performance over the past few months and almost all the indicative quantitative benchmarks for end-August 1992 have been observed. In addition, the authorities have also reformulated policies, in cooperation with the Fund, to ensure adherence to the initial program objectives.

While these actions are commendable, there is an urgent need to increase the resilience of the program, especially in the fiscal area. We welcome the authorities' steps to boost revenue by raising taxes on petroleum products and imports, reducing tax exemptions, and controlling expenditures. However, the price of petroleum products should not be set at more than the level on the international market, and it is equally important to monitor closely the results of these measures. Tax administration, in particular, should be strengthened to minimize the effect of tax

evasion and fraud on revenue performance. Meanwhile, the authorities are encouraged to continue their efforts to broaden the economy's production and export base so that revenue performance is less vulnerable to shocks in a particular sector, for example, mining.

On the expenditure side, it is important to rationalize the size of the Government and firmly resist pressures to increase the wage bill. It is indeed regrettable that past current spending overruns, including those on wages and salaries, were unfortunately offset by cuts in development expenditures at a time when the expansion of, for instance, the tradable goods sector was impeded to an important degree by poor infrastructure.

Regarding structural reforms, we commend the authorities for taking a broad range of actions and for having implemented, by mid-September this year, all structural reform measures envisaged under the first annual ESAF arrangement. We endorse the authorities' modified program and hope that the stronger and more demanding adjustment path will serve to restore the credibility of the authorities' reform and adjustment policies.

With these remarks, we support the proposed decisions.

Mr. Al-Jasser considered that the information in the staff paper was incomplete. He wondered whether Directors would wish to support the proposed increase in the price of petroleum if they were aware that the current price in Guinea was already 400 percent above the international pre-tax price in the Rotterdam market or any other international market. Such information should be included in papers in which the staff recommended increases in the petroleum prices in a member country. Such papers should also explain the possible ramifications of the oil price increase for the growth and development of the economy. The countries in question usually faced very difficult situations in terms of development and growth, and failure to take that reality into account could lead to policy recommendations that would suffocate the economies of those countries.

Mr. Abbott said that he looked forward to the staff's comment on the issue that Mr. Al-Jasser had raised. In addition, it would be useful to have the information in a readily usable form, such as the price of a liter of petroleum in Guinea in terms of the dollar or SDR.

Mr. Thorne commented that Mr. Al-Jasser had, in a sense, given part of the answer to the question Mr. Al-Jasser had posed in noting that the post-tax price of oil in Guinea was above the pre-tax price in Rotterdam. To say that the price in Guinea was 400 percent above the world price did not mean that the Guinean price was 400 percent above prices in general for world consumers. In addition, it would be useful to know what oil company profits

were, both at the wholesale and retail levels. Furthermore, externalities played a role in the determination of the price.

Mr. Al-Jasser said that statistics that he had requested from the staff showed that there apparently was substantial waste and inefficiency in the distribution system. Accordingly, that system might as well be privatized or open to international competition, so that, at the least, revenues that were lost to the Government would not accrue to the invisible beneficiaries of the system.

He had expected that someone might raise the question of the appropriate international price for petroleum, Mr. Al-Jasser remarked. As he had mentioned on a number of previous occasions, what was a good oil price policy for Europe was not necessarily good for a developing economy. In making policy recommendations, the staff should not merely imitate the established policy of certain major countries. If the staff intended to make a recommendation like the one he had questioned, the recommendation should be transparent, and the Fund should be able to defend it, especially in terms of its impact on a specific economy. For example, while, say, France had a large nuclear energy sector and the Government could subsidize it or regain the welfare losses for one sector or another, that option might not be available to Guinea or some other developing country. It was incumbent upon the Fund to keep such considerations in mind.

Mr. Papadakis made the following statement:

In today's much-delayed discussion of the first midterm review, we are presented with a new set of proposed short-term economic policy actions aiming at the continuation of what is supposed to be the same program, but in a new, adjusted version, which is hopefully more realistic than the original one. One is led, therefore, to wonder to what extent the blame should be put on unrealistic targets and benchmarks for the delays encountered in key structural reforms and the consequent large fall in external nonproject assistance.

In a medium-term perspective, I do not believe that the aims and targets of the initial program were anything less than the absolute minimum needed to reinstate a wide-ranging adjustment path in Guinea. I am glad that, in the new version of the program, at least the initial medium-term targets have been retained. It was precisely in the name of realism and pragmatism that the Fund had to accept in the first place a gradual rather than front-loaded adjustment process for Guinea. The risks involved in a gradual approach were not, of course, unknown. In last November's Article IV consultation and discussion of the first annual ESAF arrangement, the Board "underscored the importance of achieving the fiscal and balance of payments targets for 1991 and 1992 including, if necessary, through the adoption of additional policy actions."

One of the reasons--not the least important one--why the program went so much off track, so soon after the Board's approval of the first annual arrangement, was the fact that no particular measures were envisaged right from the outset as a "second line of defense" in the event of exogenous shocks or slippages in the program's implementation. The staff had, in fact, discussed with the authorities some possible areas that might be examined, if there was a subsequent need for strengthening the program. But those were only tentative discussions. They could never be the same as having ready in the drawer a sort of "crash program," to be used should the need rise. In this particular case, the need did actually rise almost at the very moment the first annual arrangement was being approved in early November. Commendably, a shadow program was subsequently sketched and put into effect in February, with the aim being to reinforce the fiscal stance and redesign the adjustment path. Since then, the authorities have been devoting courageous efforts toward containing the slippages and achieving the structural benchmarks. They accomplished this by October.

I am not fully convinced that such loss of precious time could not have been avoided, if, with appropriate assistance from our experts, the authorities, when submitting the request for ESAF support, had already in mind a predetermined set of explicitly spelled out and agreed upon optional corrective measures to be used, if needed, to keep the program on track. I certainly realize that it is not always easy to identify measures in advance without knowing the exact source of the shortfall. But the purpose here would have more than justified the effort. At least some of the exogenous and so-called "unexpected" factors, such as the ones that resulted in the sizable shortfall of mining sector receipts or the losses of the ASP, could and should have been anticipated; and counterbalancing measures could and should have been foreseen earlier. It is always better to be prepared to face, rather than to track behind, undesirable but probable events.

This becomes crucial in cases where there is no room for slippage in the timing or extent of reforms, in order to regain or retain the confidence of the international community. There had been substantial aid donor commitments since 1990, which had not been subsequently disbursed, because donors and creditors had wanted to be reassured that sound macroeconomic policies were in place. The ESAF arrangement was supposed to catalyze these disbursements. As the staff put it, in last November's discussion, the question was not whether the external disbursements would take place, but rather whether they would all take place at the same time, following the Fund Board's approval of the program, creating a funding problem. I can't say I am happy that such a "problem" has been avoided.

I am raising these points because I am afraid that a similar situation could be faced in the months to come, if the implementation of the program again starts to lag behind, despite the unquestionably reconfirmed commitment of the authorities not to let this happen. I notice, for example, that the pricing and structural policies envisaged for the next few months should have been put in place earlier. This would have helped contain public finances, as it was clear all along that the budgetary problems of Guinea were deeply rooted in the institutional and organizational structure of the economy. In the face of risks of further delay, the staff report states that "additional structural measures for 1993 will be identified in the context of the discussions on the second annual ESAF arrangement." Similarly, although the authorities' intention is clearly to reduce subsidies for urban transit, these subsidies have been left to be reviewed by Fund staff again in the context of discussions on the second annual ESAF arrangement. Furthermore, despite the obvious risks surrounding the budgetary situation in 1993--and the staff report rigorously underscores these risks--one can again find no specific measures of corrective budgetary action if needed. Instead one reads a general statement, such as "overall, fiscal policy in 1993 will be focused on a consolidation of the efforts initiated in 1992."

I sincerely hope that in the period ahead the lack of timely envisaged corrective action will not prove again to be a cause for program slippages. Indeed, I believe the authorities are to be commended for their prudence in trying to put in place an agreed adjustment program so as to help ensure that financial discipline is maintained in the months ahead and hopefully beyond. Since last February, there has been a record of renewed satisfactory performance; strong corrective fiscal measures have been put in place; and delayed structural reforms have finally been implemented, to an extent that could justify the conclusion today of the midterm review. On that basis, I can go along with the proposed decisions.

Mr. Golriz made the following statement:

The Guinean economy is encumbered by the twin problems of inefficient structure and heavy reliance on alumina and bauxite exports. As a result of the latter, the macroeconomic adjustment program supported by the Fund resource went off track when aluminum prices declined in the world market in 1991. The authorities reacted promptly, however, to bring the program back on track and adopted, in some areas, even tougher standards.

We are in broad agreement with the thrust of the staff's appraisal and support the proposed decision. Our comments, therefore, can be limited to three short points:

The revised fiscal policies include, inter alia, efforts aimed at strengthening the tax base and decreasing outlays for development projects. In this relation, we do share concern raised by Mr. Al jasser about overtaxation of petroleum products. Curtailing development projects is also of some concern since these projects could increase the productive capabilities. In this connection, we note from the authorities' letter of intent (page 32, paragraph 8) that the number of ministries was reduced in February 1992 from 31 to 17, but according to staff, the wage bill in 1992 would be almost 10 percent higher in real terms than in 1991. We wonder whether the present improvement in fiscal deficit is not all achieved at the cost of the development projects.

Second, diversification remains a task to be addressed by the authorities. The mining sector at present accounts for 83 percent of the exports and 50 percent of the government domestic revenues. Vertical expansion of the extracting industries could help establish a broad-based production and increase the country's resilience to the external shocks. Incentives are needed to persuade the private sector to invest in mining-affiliated industries.

Finally, the Government's undertakings under the program include radical reforms on pricing as well as trade and exchange rate policies, while maintaining the pace of restructuring of the public sector and privatization. To this end, the authorities are urged to make their best efforts to create an environment conducive to the mobilization of national savings.

The staff representative from the African Department, responding to Mr. Al-Jasser's comments on the price of petroleum products, said that the staff agreed that it would not be useful to rely unduly on one particular tax estimate that was likely to distort the incentive structure of the economy. However, he agreed more with the principle that Mr. Al-Jasser had described than the particular numbers Mr. Al-Jasser had cited. The retail price for gasoline in Guinea was GF 750 francs per liter, out of which the imported landed cost was GF 184. On top of that price were distribution margins by the companies of GF 106, for a subtotal of GF 290, which made the retail price only 260 percent of the landed cost, including transportation costs, which were important to take into account, especially if they were unrelated to the cost of importing. One could not *pari passu* assume that the cost of transportation, in a country where the transportation network was not as developed as one might wish, was such that automatically one would need to lower all the components of the costs down the line. The customs duty on petroleum products was GF 47, and the specific retail tax was GF 425. Hence, the tax, as a proportion of the landed cost, including transportation, was about 160 percent. It was useful to go beyond those numbers and to consider what might be the optimum tax on a commodity like

oil, or any other commodity, and what should be the contribution of that revenue to the economy's total resources and to its cost structure. A paper on those subjects was being prepared by the Fiscal Affairs Department for the consideration of the Board.

Many West African countries relied importantly on petroleum taxes for a number of reasons, the staff representative continued. All those countries had a low level of income and a very narrow tax base, and they naturally took every opportunity to expand the tax base on incomes and establish appropriate tax rates on incomes and profits. Progress had been made in improving the efficiency of customs administration, but, ultimately, the main areas of tax were petroleum products and imports. In Guinea, the share in total domestic revenue of taxes on petroleum products was only 18.6 percent, even after the 55 percent increase in the excise duty on petroleum products. That figure was far lower than the comparable figures for many other African countries. Similarly, the share of customs duties in total revenues in Guinea was 16.4 percent, which reflected the fact that revenues from the mining sector contributed some 50 percent of domestic revenue in Guinea. If the revenue from the nonmining sector was excluded, the shares of petroleum taxes and customs duties in total nonmining revenue amounted to 31 percent and 27 percent, respectively. Those shares were not excessive in comparison with the shares of many other African countries.

The petroleum tax revenues in Guinea were only 2.4 percent of GDP, the same share as taxes on incomes of individuals and companies, the staff representative continued. The current gasoline retail price per liter in Guinea was \$0.82, compared with \$0.79 a year earlier and \$0.63 in 1990 and 1991. That increase was not excessive in the context of world prices. Over the past several months, the retail price in the Gambia was \$0.82 per liter and in Ghana it was \$0.36 after the latest weakening in the exchange rate in the face of unchanged domestic prices, and \$1.35 in Côte d'Ivoire. Hence, prices in Guinea were not higher than prices in neighboring countries. That was an important issue, given the potential for buying from one country and selling in another; indeed, that was a key factor in deciding how high the tax on petroleum products should be.

Another argument for a significant tax on petroleum products in Guinea and other developing countries was the virtual impossibility of raising revenue from any other source, the staff representative commented. In the absence of sufficient foreign financing, the authorities had to rely on domestic resources. Poor countries could not be deprived of the opportunity to raise revenue in the petroleum sector if that was the only important revenue source. After all, speakers had suggested that the pace of fiscal adjustment in Guinea might not be fast enough; one could not have it both ways. It was important to bear in mind that, while developed countries could rely on revenues from user fees and tolls in the transportation sector and elsewhere in the economy, Guinea and many other African countries did not have that alternative.

For all those reasons, the staff felt that the tax on petroleum products in Guinea was not excessive, even though it had been increased; indeed, the tax in Guinea was lower than the tax in other countries, the staff representative commented. As to the tax rate and the imported landed cost in Guinea in comparison with other countries, Guinea, along with many African countries, was doing far better than other countries in the world. The available data showed that the tax rate in Africa was less than half the rate in the OECD countries, which reflected the low standard of living in the African countries; it would be inappropriate to overburden the population with excessive costs, even if that was simply to bring the African countries up to par with other countries. Perhaps the prevalence of sizable petroleum taxes in many countries suggested that such taxes might have some validity..

The 60 percent contribution of the increase in petroleum tax receipts to fiscal adjustment noted by Mr. Al-Jasser was correct, but it took into account the total receipts from petroleum taxes, not only the increase in the tax rate itself, the staff representative commented. In other words, any particular revenue yield from taxes on petroleum products reflected the combined impact of the removal of duty exemptions--which was significant in the case of Guinea--and improvements in administration. Of the 750 beneficiaries of exemptions, 600 had recently been removed from the rolls in May 1992, including contractors for the implementation of government projects, and there had been more rigorous implementation of the exemptions enjoyed by mining companies, the staff representative remarked. The main reason for the slippages in the collection of taxes on petroleum products was the diversion of imports that were to be used by mining companies, which were exempted from the tax, and by the contractors of public sector projects, who were also exempt from the tax, the staff representative remarked. Those companies and contractors had taken more than was due to them and had then directed supplies to the market without paying any taxes. That had been the main source of tax evasion and fraud. The staff certainly agreed with Directors who had stressed that the authorities would need to be more diligent in strengthening the tax administration, and the progress in that connection that had been made since May 1992 was welcome.

Recent data provided evidence of some weakening of revenue performance, the staff representative commented. In September 1992 there had been a shortfall in tax receipts on petroleum products. Apparently, the most likely explanation of that development was that, before it was privatized, the public entity involved in the distribution of petroleum products, used the proceeds from taxes to cover its outstanding lines of credit that had to be repaid, and paid the Government only the net residual. The budget provided for GF 11 million to cover the cost of privatization, as well as GF 2.7 billion to cover the cost of severance pay for the 700 employees of the privatized petroleum company. That was a point that the staff intended to check during the forthcoming mission to Guinea.

The circumstances of Guinea at the start of the ESAF program had been very difficult, the staff representative commented. The wage increases in

1991 were excessive by any standards, and the authorities had thus given themselves very little room for maneuver to reduce government expenditures, if necessary, in order to stay within the framework of the fiscal program. At the time, the wage increases were seen as necessary to maintain the political consensus in support of the adjustment efforts, particularly in light of the large increases in administered prices, such as the 100 percent electricity price increase, and the 50 percent transportation and water charge increase. It was felt that, given the very low level of wages in Guinea, there should be some balance in the wage area; the actual balance was not necessarily the optimum.

During the first half of the current annual arrangement, there were exogenous shocks in the form of reduced earnings from mining companies, as well as slippages in government expenditure, the staff representative recalled. That situation was compounded in early 1992 by a sharp decline in the terms of trade, which, in any other country, even with a much better record of performance, would have presented very difficult adjustment needs. The loss of income because of the deterioration in the terms of trade was equivalent to 2 1/2 percent of GDP in real terms--a substantial cost to which to adjust in just one year. The staff had recommended that the authorities spread those costs over two years, so that the authorities could return to the original targets for 1994 after the economy was allowed to adjust in large part by stronger fiscal adjustment, given the worsening of the external environment. In addition, requests for additional assistance from the donor community seemed to be inevitable.

Table 7 showed that the primary deficit, excluding mining revenue--which was exogenous as far as the Government was concerned--was to be reduced from 4.3 percent in 1991 to 3.1 percent under the original program and 2.1 percent under the shadow program for 1992, the staff representative said. Given the additional slippages, the deficit would probably fall to 2.5 percent of GDP, which was still below the original target. By 1994, the primary deficit would be reduced to 1.1 percent of GDP, compared with the original target of 2.9 percent. Hence, the pace of fiscal adjustment, in the face of a worsening external environment as well as domestic slippages, had picked up. The fiscal and external positions had been much more unfavorable at the start of the adjustment program than at present. That did not mean that henceforth the authorities could afford to slow down or that they could feel complacent about what they had achieved; nor should they feel that all that needed to be done had been done.

The staff had tried to propose an adjustment program that was both realistic and tough enough to get the country where it needed to be, given the external constraints, the staff representative noted. The authorities had encountered many difficulties in implementing the fiscal measures effectively. The Government had finally been able to move ahead, and the staff hoped that more progress would be made in the coming period.

A number of speakers had mentioned the need to add to the structural measures that would need to be implemented in the rest of 1992 and in 1993,

the staff representative commented. The present midterm review was late because of the various events that he had described. Normally, a midterm review dealt only with the remaining period of the current program year; it did not cover the program for the subsequent year. The staff planned to address the program for the second year of Guinea's arrangement during the next mission, in the second half of November 1992. As the end of the fiscal year was near, the staff had wished to reassure the Board and Guinea's donors that there would not be a program for a period of just two months; the staff and the authorities had also reached broad understandings on a program for 1993. That was why the letter of intent contained commitments with regard to the level of the budget deficit as well as the key aggregate figures mentioned in the staff report. In particular, the authorities had made a commitment with regard to the most sensitive item--the wage bill, which was to be limited to an increase of 15 percent, including 12 percent for the targeted average inflation rate plus 3 percent for the impact of the normal wage drift, as well as the salaries of the parliamentarians who were going to be elected in December, and new judges and magistrates who were to be installed following the reform of the judiciary. With regard to having options, as suggested by Mr. Papadakis, the original program included a commitment by the authorities to take up measures to correct any fiscal slippages, but, unfortunately, such measures were impossible to implement in the short time left. The staff hoped that the authorities' record would improve in the coming period.

The decline in Guinea's exports to the former Soviet Union had resulted from the temporary suspension of exports of bauxite by the Kindia Bauxite Office, before the change from barter trade to trade in convertible currencies, the staff representative from the African Department remarked. The staff had been informed by the Guinean authorities that they had reached a preliminary agreement with Ukrainian partners to start trading in convertible currencies. That was a first step; the staff hoped to see a resumption of trade in that direction.

Mr. Al-Jasser remarked that the Fund could take pride in the fact that it had steadfastly refused to accept the generally prevalent dogma in the 1950s and 1960s, and even the 1970s, when socialized public sectors were predominant, especially in the developing countries. The fact that some countries were imposing high taxes on oil and did not care greatly how high the price of such an essential product became, was not an argument that *such an approach was right and other countries, too, should do the same.* The Fund should continue to critically review popularly accepted ideas.

In considering a country's oil price policy, it was the international price compared to the retail price--and the extent to which the difference was accounted for by a tax--that really mattered, Mr. Al-Jasser said. In considering the health of Guinea's economy, it was important to note that the price of petroleum products in Guinea was about 4.7 times the international price. The staff should have analyzed that situation. The staff paper did not assess the impact of the high price, caused by taxes and, of

course, inefficiencies. Merely noting that other countries in the region were following such distorted pricing policies was not sufficient.

Guinea already maintained a 12 percent customs duty, Mr. Al-Jasser remarked. If conditions in the country were as difficult as the staff had implied, he wondered why the authorities were not considering raising customs duties across the board. In Guinea and other countries--he had raised the same issues three years earlier, during a discussion on Senegal--the Fund had to face the need to come to grips with the pricing issue and address it more forcefully than it had been willing to do. The Fund had been somewhat careless in its assessment of members' taxing and pricing of petroleum products, especially in the very developing countries whose economic viability was at stake. Claiming that those measures did not affect the growth potential of the economies in question was a disservice to those countries as well as to the Fund.

Mr. Santos thanked Directors for their comments, and particularly for their support of his authorities at the current difficult juncture. The staff had shown great understanding of the authorities' situation, and the authorities were especially grateful for the trust that was placed in their capacity to implement the measures needed to achieve the medium-term objectives of the original program. While the establishment of a track record had been difficult, and a cause for much stress among his authorities, the outcome of the present discussion showed that the efforts had been worthwhile. More important, though, was the fact that the authorities were confident that the successful implementation of the shadow program would provide a sound basis for further progress to be achieved under the second ESAF arrangement. They looked forward to resuming the discussions with the staff.

The Executive Board approved the following decisions:

Enhanced Structural Adjustment Facility - Review Under First Annual Arrangement

1. Guinea has consulted with the Fund on its economic and financial program for 1991/92 in accordance with paragraph 2(c) of the first annual arrangement under the enhanced structural adjustment facility (ESAF) for Guinea (EBS/91/175, Sup. 2, 11/19/91).

2. The letter dated September 28, 1992 from the Minister of Planning and Finance, the Minister of Foreign Affairs and International Cooperation and President of the Economic and Financial Coordination Committee, and the Governor of the Central Bank of the Republic of Guinea shall be attached to the ESAF arrangement for Guinea, and the letter dated September 28, 1991 from the Minister of Economy and Finance, the Minister of Planning and International Cooperation, and the Governor of the Central Bank of the Republic of Guinea, together with the joint Memorandum on the

Economic and Financial Policies of Guinea, shall be read as supplemented and modified by the letter dated September 28, 1992.

3. Accordingly, the indicators referred to in paragraph 2(a) of the first annual arrangement under the ESAF for Guinea shall include the benchmarks for 1992 set out in the table annexed to the letter dated September 28, 1992.

4. The Fund determines that the mid-term review of Guinea's program contemplated in paragraph 2(c) of the first annual arrangement under the ESAF for Guinea (EBS/91/175, Sup. 2, 11/19/91) has been completed and, notwithstanding the non-observance of the performance criteria applicable at the end of December 1991 to the net domestic assets of the banking system, the net claims of the banking system on the public sector and on the Government, the limit on external payments arrears of the Government, and the number of civil servants, Guinea may request the second loan specified in paragraph 1(c)(ii) of the first annual arrangement.

Decision No. 10179-(92/131), adopted
October 30, 1992

Decision Concluding 1992 Article XIV Consultation

1. The Fund takes this decision in concluding the 1992 Article XIV consultation with Guinea.

2. As described in EBS/92/161, Guinea maintains exchange restrictions in the form of limits on travel allowances and on unrequited transfers, in accordance with Article XIV, Section 2. The Fund encourages Guinea to eliminate these restrictions as soon as possible.

Decision No. 10180-(92/131), adopted
October 30, 1992

2. ST. VINCENT AND THE GRENADINES - 1992 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1992 Article IV consultation with St. Vincent and the Grenadines (SM/92/185, 9/23/1992). They also had before them a background paper on recent economic developments in St. Vincent and the Grenadines (SM/92/188, 10/1/92).

Mr. Clark made the following statement:

Since the last Article IV consultation, the economy of St. Vincent and the Grenadines has continued to perform favorably, notwithstanding a slowdown in economic activity. As a result of

adverse weather conditions, banana production declined by some 22 percent in 1991 from 1990. Real GDP, however, is expected to pick up and is estimated at approximately 6 percent for 1992. Growth will be led mainly by a recovery in the banana industry, and strong growth in the tourism and construction sectors.

Underpinning St. Vincent and the Grenadines' good economic performance over the past several years has been the authorities' continued firm adherence to very prudent and effective fiscal policies. In line with previous years, the consolidated public sector surplus is projected to average 8 percent of GDP in 1992, with the current account surplus of the Central Government contributing some 4 percent of GDP to this total. Cognizant of the need to restrain current expenditures in the future, it is my authorities' intention to contain wage increases by streamlining employment in the public sector.

As regards the current account of the balance of payments, considerable variability, owing to the fluctuation in export receipts, has led to the emergence of alternating surpluses and deficits in successive years. However, while export receipts have shown no clear growth over the 1987-92 period, capital inflows, concessionary borrowing, and direct private investment have more than covered the current account deficit, thus leading to broad equilibrium in the overall balance.

Notwithstanding the overall favorable performance of the economy, my authorities continue to be very concerned about the unfavorable medium-term outlook for the banana industry in view of the pending Single European Market, and the possible impact on employment levels. While discussions are still continuing on the treatment of Caribbean bananas, the uncertainty that the industry faces has not been without costs. My authorities would hope that a favorable solution will be arrived at by the European Commission in the not too distant future.

In order to address any eventuality, my authorities are proceeding with their diversification efforts within the agricultural sector and across sectors, but this is proving extremely difficult. They anticipate that any early movement out of banana production will only take place if the returns on alternative activities are comparable to those under the present situation as regards banana cultivation.

With regard to the survival of the banana industry, my authorities are cognizant of the need to become more competitive and are aware that this can only come about through improved quality, lower costs, and higher yields per acre. In attempting to improve banana quality, on October 1, 1992 my authorities scrapped the old system for the determination of procurement

prices. They have introduced in its place a tiered pricing system that is directly linked to the quality of the fruit produced.

Regarding costs, my authorities understand the difficulty in adjusting wages downward in the absence of a curtailment of benefits currently received by the banana sector. This being the case, they are currently heightening awareness among banana farmers of the importance of raising productivity levels in the industry. They anticipate that some improvement in competitiveness will come about through higher yields per acre, but they are constrained when compared with their Central and South American neighbors, owing to small-scale production and topographic conditions.

With respect to diversification across sectors, my authorities know only too well that structural factors, such as the relatively low level of infrastructure, are serious impediments. To this end, they have begun to substantially upgrade infrastructure so as to allow for expanded opportunities in tourism, agriculture, and manufacturing. With significant improvements in infrastructure, including better transportation, they believe that manufacturing and export processing would expand at existing labor rates. Furthermore, they see such an investment strategy as leading to expansion of credit for private sector investment in improved farms, hotels, and factory sites.

My authorities are aware that broadening of the productive base and increasing competitiveness will take time. In the interim, they are mindful of the potential ramifications that the implementation of the North American Free Trade Agreement (NAFTA) could have for developing countries in the region. They are hopeful that the Caribbean Common Market (CARICOM) countries would not be disadvantaged by NAFTA, and that the benefits of the Caribbean Basin Initiative (CBI) and CARIBCAN would be maintained.

Mr. Bindley-Taylor made the following statement:

Despite its vulnerability to external shocks, St. Vincent has *maintained in the recent past an average annual growth rate of real GDP in excess of 7 percent.* While good weather and rising export prices have played a role in this, we believe that good developmental strategy, appropriate policies, and sound economic management have in no small measure contributed to the strong economic performance to date.

Commendable fiscal prudence has been the cornerstone of the country's economic performance. Over the last six years, public sector savings has averaged around 8 percent of GDP. Even when the Central Government embarked on a sizable increase in capital

expenditure, the fiscal current account surpluses, together with capital grants, were enough to ensure that a small but declining surplus was maintained in the overall fiscal position until 1991, when a small deficit emerged. In addition, judicious external borrowing on concessional terms contributed to the expansion in capital without having any substantial impact on debt servicing.

In the monetary sector, credit to the private sector expanded at rates substantially in excess of increases in money and quasi-money, but the large surplus of the nonfinancial public sector resulted in net domestic assets growing at a slower pace than the money supply. As a result, over the period 1987 to 1990 net foreign assets increased substantially.

Notwithstanding this good performance, there are areas of concern that we feel the authorities need to address. We believe that the rapid expansion in credit to the private sector in the period 1987-91, which was facilitated by the surpluses of the nonfinancial public sector, reflected the substantial gains in real income over the period. However, expected lower receipts of foreign grants, the continuation of the public sector investment program (PSIP), and the recurrent costs associated with the recently completed capital projects, imply lower public sector surpluses in the future and a need for more cautious growth in private sector credit. This points to the need to strengthen the fiscal accounts and to improve the performance of the nonfinancial public sector. We, therefore, welcome the authorities' intention to strengthen revenue generation through tax reform and to restrain growth in recurrent expenditures, particularly the wages of the civil service.

With respect to the rest of the public sector, divestment, where possible, is recommended, while the current system of investing a large percentage of the assets of the National Insurance Scheme (NIS), in fixed deposits at interest rates below market, should be discontinued and the NIS allowed to invest its liquid assets in areas that promise higher rates of return.

Clearly, growth of nominal wages has begun to undermine the competitiveness of the small domestic manufacturing sector, constraining its growth and further reducing the limited options for diversifying the economy. Relatively high wages have also complicated the process of improving productivity and competitiveness in the labor-intensive area of export agriculture. Furthermore, wage expectations, in excess of the minimum wage rate, may be a contributing factor to voluntary unemployment, thus contributing to the already high unemployment rate in the island. Given their inability to use exchange rate realignment as a policy measure, the authorities must, therefore, concentrate on curtailing the increase in public and private sector wages and

seek to increase levels of productivity through structural and administrative reforms in both the public and private sectors.

The staff's medium-term outlook, even though it assumes a substantially conservative estimate for banana exports, gives a relatively comfortable outlook on the external sector. The critical issue in the medium term, however, is the possible demise of the island's major export crop, bananas. The traditional market for Vincentian banana imports has more to do with the island's status as a former British colony than as a competitive producer of bananas. In this traditional trading relationship, substantial resources of land, labor, and capital were devoted to producing a crop that was sold exclusively in a noncompetitive market. The profitability within these arrangements more or less ensures that no other domestic agricultural crop or economic activity receives as much resources or infrastructural support, thus reducing the motivation to search for or develop any short- or long-term alternate crops. Moreover, the exclusive market arrangement protects the exporters from the discipline of international competition. Diversification in this context is only relevant if the contemplated new area of economic activity can provide either the equivalent or additional benefits compared to the dominant export activity.

The threat of removal or reduction of preferred status normally finds countries such as St. Vincent without alternate economic activities and with serious cost and quality differentials existing between themselves and their international competitors.

The key question that must be answered is, can St. Vincent become a competitive banana exporter in the absence of a preferred market? More importantly, have the St. Vincentian authorities done, or do they propose to do, any in-depth market studies on this matter, or on the feasibility of alternate areas of potential export? Perhaps the staff or Mr. Clark can enlighten us on the issue. In the absence of this, it seems wishful thinking to assume that productivity gains and the enhancement of quality will suffice to keep the industry alive and in competition with Central and South America after 1993.

On the other hand, an alternate form of economic activity requires either an orderly transitional period, or promises severe social and economic dislocation. In this context, we are concerned that the new agreement of the European Commission, which seeks to protect the market share of African, Caribbean, and Pacific countries (ACP) producers, has not become effective and, more importantly, there is no announced time frame for the duration of this new arrangement. At the same time, we note that the authorities have generously concluded that a time frame, when

announced, would be at least for the next four to five years. We are uncertain as to their grounds for this assumption, but we would urge the authorities to use whatever respite they may receive under Lomé to sit down with the local private sector and the farmers in order to explore every conceivable viable export prospect that individually and/or collectively can replace the role of banana exports in the economy.

On a related matter, we note the relative weakness of statistical data on certain critical economic variables in the island. We urge the authorities to strengthen their statistical base, as it can only improve the quality of their economic information and decision making.

Mr. Barr made the following statement:

The authorities in St. Vincent once again deserve commendation for the steady economic performance since the last Article IV discussion in 1990, and in particular the continuation of a strong fiscal position. I agree with the recommendations in the paper, and I will confine my remarks to a few points.

First, the public sector investment program, largely targeted on transport, communications, and agriculture, is clearly an important component in developing St. Vincent's economy, and in particular diversifying out of bananas. It is reassuring to show that the majority of this expenditure is being financed from the strong public sector current balance. However, I notice that the overall public sector balance, although it is still relatively small as a share of GDP, has widened to a deficit of around 3.5 percent. Such a level does seem sustainable, given that it was more than financed by foreign concessional loans, as Mr. Bindley-Taylor pointed out. But the authorities should be mindful of a widening overall public sector deficit over the medium term.

Wage growth is the other obvious area where the authorities will need to be vigilant. Given the exchange rate arrangements and the aim of further diversification into up-market tourism, excessive wage growth could quickly erode any competitiveness in this area. I was also struck by the extent of the spread between lending and deposit rates, particularly given the cautious domestic lending policies of the commercial banks and the fact that all such lending requires collateral. A spread of more than 7 percent seems very high, notwithstanding the small scale of private business activity in St. Vincent, and it would indicate the need for greater competition in this sector. More competition might also help to attract greater venture capital into St. Vincent to help promote diversification into small-scale

enterprise activity. I would be grateful for the staff's or Mr. Clark's views on the potential merits of this.

I agree with Mr. Bindley-Taylor that, at least over the short-term horizon, the balance of payments position appears viable. Having said that, I was rather concerned to see the size of errors and omissions in the capital account in Table 4. Could the staff comment on whether there was any risk of the real underlying position of the capital account being much worse than that estimated in the paper. Like Mr. Bindley-Taylor, I wonder what measures in particular were being taken to improve these capital account statistics.

Clearly, diversification in an economy as small and as concentrated as St. Vincent's will not be easy. The authorities should take some comfort, however, from the EC Commission's proposals on bananas under the European Single Market. Although these are still being discussed, they seek to fulfill the commitments given to ACP producers under the Lomé Convention, while trying to balance this with GATT objectives and a successful conclusion of the Uruguay Round. This is not an easy task, perhaps illustrated by the fact that no party to these negotiations seems entirely content.

I would strongly urge the St. Vincent authorities to take this opportunity to establish a medium-term plan to encourage further diversification. In this regard, I strongly welcome the new tiered pricing system described in Mr. Clark's statement, and I would urge the adoption of further measures outlined in the staff paper; for example, fiscal measures to force out marginal producers. Without such measures, given the comparative benefits and securities that farmers have under the existing system, transition will be a very slow process, and St. Vincent may find itself in a very vulnerable position in a few years' time. I can support the staff appraisal.

Miss Creane made the following statement:

There is much to praise and little to fault in St. Vincent's economic performance to date. The authorities have followed a responsible policy path that has resulted in growth and inflation rates that most of us would relish. There has been a commendable will and ability to pursue solid fiscal policy and external debt management, as the Government has resisted short-term temptations in favor of a longer-term payoff.

That we focus our attention today on the medium-term outlook only underscores the positive past and current economic outturns. Still, the staff's medium-term scenario, showing falling rates of

saving and investment over the next five years, in line with declines in exports and transfers, highlights the need to take supplemental policy measures now to prevent any deterioration in economic conditions later.

Our concerns focus on the need to provide for a more stable balance of payments outlook. That the volatility of the current account balance in recent years is tied directly to the ups and downs of the banana sector would point to the need to diversify production, even without the added uncertainty of prospective changes in world banana demand caused by potential EC decisions, and in world banana supply caused by recent added banana production in Latin America. Given that the need for alternative production sources was already an issue at the 1990 Article IV review, one wonders why the investment necessary for diversification is as yet not forthcoming.

The authorities have appropriately aimed public investment priorities at improving the transportation and communications infrastructure within the country. But one should also consider why greater private investment--whether domestic or foreign--is not available. The staff report, and the other speakers have already drawn attention to, the competitiveness of domestic wages. Although there seems to be some contradictory information--for example, the background paper on recent economic developments suggests that wages in certain industries are competitive with trading partners--overall, it appears that domestic wages in St. Vincent are among the highest in the region. We would echo the staff's recommendations that the authorities employ those tools at hand to help minimize wage growth by tempering wage increases in the public sector and in the minimum wage. Of course, if special preferences for the banana sector are lowered, these adjustments would automatically, and potentially more severely, work through the economy, pushing labor costs down.

Another structural problem potentially limiting the extent of diversification today is the lack of venture capital in St. Vincent. Rather than providing the type of medium-term lending needed for productive private sector investment, the existing banking sector is primarily focused on safe-bet collateralized and mortgage lending, and it is further characterized by a large gap between deposit and lending rates. Although a fair number of different financial institutions are present in St. Vincent, it seems that the dominant role and special preferences of the state-owned commercial bank might be effectively stifling competition. We would suggest, at a minimum, looking into the potential for eliminating some of the state bank's special preferences, such as its exemption from the deposit tax and its monopoly access to below-market-rate compulsory deposits of the national insurance company. At the maximum, as the

authorities are considering divestiture of other public enterprises, in addition to the dairy company, consideration might also be given to privatizing the state commercial bank. In addition, the combination of tax incentives for mortgage lending and an extremely high tax burden for financial institutions might also be a barrier to the entry of an institution that might provide the type of medium-term lending needed for investment in alternative production.

On other issues related to policy management, we fully support the authorities' intention to launch a comprehensive tax reform and enhance tax administration, and we would recommend elimination of minor taxes, such as that on exchange transactions, which generate little revenue, but are yet distortive. We also encourage any inclination for other improvements in the trade regime, including removing remaining licensing requirements and a potential overhaul of the common external tariff.

Finally, we were rather startled to read of the very poor quality of statistics available. The absence of basic data on trade and employment must surely complicate policy decision making. Given the relatively comfortable fiscal position, the need to allocate some resources toward improving the statistical base would seem to be a clear priority.

Overall, however, we have full confidence in St. Vincent's economic prospects, in the belief that the authorities will continue their solid and able policy performance now and in reaction to any future events.

Mr. Matthews made the following statement:

When the Board last considered the economy of St. Vincent and the Grenadines two years ago, this chair welcomed both the good macroeconomic performance of the economy and the authorities' pursuit of prudent fiscal and financial policies. However, we cautioned that the medium-term outlook was clouded by an inefficient and narrow production base. These same comments still apply, even though we are now two years closer to reaching the medium term.

Economic performance over the past two years has been generally good, though somewhat mixed. On the positive side of the ledger, real GDP has continued to grow at very respectable rates. Even in 1991, when adverse weather conditions resulted in a 22 percent decline in the production of the primary cash crop, GDP growth was still almost four times that achieved, on average, by the industrial countries. Furthermore, direct private investment and concessionary official borrowing have

maintained the overall balance of payments in equilibrium, despite considerable variability in the current account. On the negative side, excessive wages growth has added to the price effects of the elimination of some price controls.

I agree with the staff report and Mr. Clark's statement that the foundations of this generally good economic performance have been the prudent fiscal policies adopted by the authorities. The continued ability of the authorities to generate savings of some 8 percent of GDP on the current transactions of the consolidated public sector augers well for the continued expansion of infrastructure that will be vital for the process of diversification, a subject that I will return to later.

The authorities' intention to maintain prudent fiscal policies is to be welcomed, as is their recognition of the need to enhance the public sector's revenue base. However, I wonder how the authorities' intention to reduce marginal income tax rates will help in achieving their fiscal policy goals. Of course, income tax evasion can be a serious problem, but a reduction in marginal income tax rates to reduce evasion could possibly make more sense if accompanied by an increase in taxation on consumption.

The operation of monetary policy by the Vincentian authorities attracts surprisingly little attention in the staff report. From the statistics provided, it appears that money growth has been broadly set to accommodate economic growth. However, I would appreciate the staff's views on the causes of the approximately 900 basis points spread between deposit and lending interest rates, and whether this large spread may be one of the causes of the apparent lack of domestic bank credit for investment purposes.

Looking toward the medium term, the two key issues facing the Vincentian authorities are how to improve the efficiency of banana production and how to effectively strengthen the productive base of the economy. Vincentian banana production represents a good example of the familiar problem of the inefficiencies that develop when production occurs behind a wall of protectionism, this time thanks to the preferential trade arrangement with the United Kingdom. Quite clearly, a very wide gap exists between St. Vincent and exporting countries in Central and South America in both the efficiency of production and the quality of product. Indeed, given the large differential between banana prices in the United Kingdom and other parts of Europe, it is somewhat surprising that the recent consumer opposition within the United Kingdom to the continuation of preferential access had not occurred earlier. While the authorities may hope for a favorable solution to negotiations over the treatment accorded to bananas upon the creation of the Single European Market, every effort must

be made by the authorities to improve production techniques. Production costs must be reduced, average acreage of plantations increased, and yields and quality improved if the medium-term viability of this industry is to be ensured.

Of course, diversification of the productive base of the Vincentian economy can help to ensure the maintenance of strong growth in GDP. However, the authorities need to be careful not to pursue diversification simply for the purpose of establishing the capacity to produce a wider range of goods. Rather, diversification should be pursued only in those areas where the Vincentians can compete effectively without support or protection. In this regard, experiments with light manufacturing, which at one stage saw tennis racquet exports rise to 11 percent of total exports, appear to have had limited lasting success, with the closure of three enterprises in 1990 and 1991. I agree with the staff that tourism and agriculture represent two industries in which the greatest potential for the development of productive capacity lie.

In his statement, Mr. Clark notes that it is proving extremely difficult to encourage banana farmers to shift into other fields. This is probably not surprising, given the financial attractiveness of producing bananas. Nevertheless, the uncertain outlook suggests that every possible action be taken to encourage inefficient producers into other areas. The introduction of a tiered pricing system early this month should help in this process. The introduction of a tax on exports could also help in smoothing the process of transition. Further, a more efficient allocation of resources would be promoted by a rationalization of the existing system of tariff protection.

The concentration of the PSIP on improving transport and communications infrastructure will be particularly beneficial to tourism. Yet, despite the substantial investment that has already occurred through the PSIP, production trends do not appear to be responding. Despite the limited success to date, the authorities' practice of focusing tourism development at the upper end of the market seems to be a sensible approach, given the relatively small current and prospective capacity, and the fragility of the local environment.

The staff appears to believe that efforts to diversify the economy are being thwarted by relatively high wages in St. Vincent. While this may be the case in the agricultural sector, the existence of higher wages in the tourism sector is not necessarily a problem. Indeed, high relative wages provide the appropriate price signal to encourage labor resources to move into the tourism sector. I note in this regard that the staff paper indicates that wage levels in the Vincentian tourism sector are

lower than in neighboring tourist destinations. I would be interested in hearing the staff's views on whether limited capacity is currently restraining the potential for further growth in tourism, or whether demand-enhancing measures, such as a more effective marketing campaign, could increase tourist numbers.

The Vincentian authorities have shown that, through the adoption of prudent financial policies, good economic outcomes can be produced. The challenge facing them now is to adjust to a changing world environment.

Mr. Martinez-Alas made the following statement:

It is always reassuring to review a small developing economy operating under a sound macroeconomic framework. The business of the government is essentially one of providing a stable macroeconomic environment. In this regard, the Vincentian authorities' perseverance in maintaining macroeconomic discipline is to be commended. Inflation continues to be low, the balance of payments has shown surpluses more often than not--since 1988, the public sector has run overall surpluses every year but in 1991--and the current exchange rate arrangement has served St. Vincent well.

Despite these positive policy developments, St. Vincent and the Grenadines' policymakers are facing a very important challenge, namely, how to redirect its overall pattern of development in light of both the ongoing worldwide structural change and their own endowment of resources. In this context, a worrisome symptom appears: the pace of real growth in the Vincentian economy is decreasing rather rapidly. The real GDP rate of growth decreased from 8.9 percent in 1988 to 3.3 percent estimated for 1991. There are several reasons for this. The well-known vulnerability of agricultural economies to the variability of weather conditions is one of the most important causes. Structural rigidities, however, also play a role.

The efforts of the St. Vincent Government have been rightly concentrated on providing physical infrastructure, mainly in transportation, energy production, and communications. Those efforts are aimed at providing the conditions for reversing the narrowing of the export base. According to the staff report, the Vincentian authorities seem to have had little success at diversifying the export base. In this regard, two factors should be considered when assessing the Government's role in this area. First, some structural impediments in the financial and labor markets may be at work. Second, we should keep in mind that such a structural shift of the production base is bound to take longer than we may like. Furthermore, some transitional output decrease

would have to be tolerated and cushioned through some explicit and transitory mechanism.

The staff paper echoes the authorities' concern with regard to the difficulties in providing incentives to banana producers to shift to other export-oriented activities. One step in the right direction should be to allow the banana sector to be fully affected by its relatively lower productivity. A market-signaled reduction in the profitability of banana production should send the right signal for producers to move to other sectors.

We are fully aware that the size of the Vincentian economy imposes practical constraints on the availability of investment and production opportunities. It also imposes practical constraints on policy choices. Nonetheless, the implementation of structural measures on taxation, the financial sector, and the labor market seems to be urgently needed.

Needless to say, due regard should be given to the fact that St. Vincent is an island economy with a fragile and unique ecology. In this regard, the "up-market" approach to tourist development is well advised.

On fiscal policy, the performance of the Vincentian public sector is highly commendable. We encourage the Vincentian authorities to continue their exemplary behavior in sustaining a very sound fiscal framework. The public sector has been running current account surpluses for the past seven years. The overall balance has been positive almost every year since the mid-1980s. The observed higher levels of public investment have been financed with domestic public savings and external loans in concessional terms. In addition, a reduction of the net indebtedness of the public sector has been possible. Nonetheless, future prospects seem to be clouded. On one hand, the bulk of current revenues comes from taxes on international trade and transactions. On the other hand, the wage bill continues to increase steadily.

In this context, the Vincentian authorities should weigh carefully the trade-off between revenue collection, and the elimination of trade distortions and excessively high levels of protection to domestic producers. In order to foster a nondistortionary climate for more diversified private investment, existing nontariff barriers should be eliminated and tariff levels should be decreased. More reliance on domestic consumption taxes seems to be necessary.

On financial intermediation, distortions in financial markets could arise from differentiated tax treatments for public and private banks, and from an interest rate floor on savings

deposits. This could partially explain why the banks are discouraged from lending for private investment.

On labor markets, high unemployment coupled with a shortage of skilled labor continues to persist. The persistence of this apparent contradiction calls for an urgent assessment of the prevalent set of incentives in the Vincentian labor market. It also seems to be important to establish the appropriate schemes to train workers in the technical skills needed to advance the long-term process of economic development.

In general, a sound macroeconomic framework is in place and the Government is successfully addressing the bottlenecks in the physical infrastructure. The agenda ahead must place a high priority on removing remaining structural impediments so that private investment can take place.

The Vincentian authorities have been successful at maintaining fiscal discipline. They are now faced with the task of fostering a long-term development strategy that should be aimed at influencing growth rates through incentives to agents in knowledge-producing, human-capital intensive sectors. In addition, the authorities must sustain a stable macroeconomic environment in order for the private investors to undertake the risk of shifting the productive base away from bananas.

The staff representative from the Western Hemisphere Department said that the authorities were concerned about the possible demise of the banana sector. There was no clear agricultural alternative, and the consensus was that it would be very difficult to move farmers away from bananas as long as they remained the preferred crop and continued to be profitable. The authorities had been looking into manufacturing and tourism. Tourism seemed to be the best alternative, as the movement into manufacturing had been hampered by wage problems.

As to the wage situation, available information indicated that St. Vincent might be competitive in some areas with neighboring countries in the Caribbean, the staff representative pointed out. However, wages for manufacturing in St. Vincent were higher than in some countries, such as the Dominican Republic or Mexico, particularly in the assembly industry.

There were two reasons for the large spread between borrowing and lending rates, the staff representative said. St. Vincent was a small market covered by five banks with rather high operating costs, which precluded benefits from economies of scale. In addition, the banks were subject to a 45 percent income tax, plus a 15 percent tax on profit remittances, which added to the spread. The four foreign-owned banks were also subject to a 1 percent tax on their deposits, while the National Bank was not.

The growth of the public sector deficit over the past few years reflected, to a large extent, the work done to upgrade airports, which was financed with foreign loans, the staff representative said. The general fiscal structure that the authorities wanted was one in which grants plus the current account surplus would finance the investment budget, aiming toward an overall balanced position.

The large negative errors and omissions in the balance of payments was a statistical phenomenon, the staff representative pointed out. It reflected mostly the commercial banks' deposits of foreign exchange abroad or with the Caribbean Central Bank. It was difficult to disentangle those deposits from errors and omissions. During the 1992 Annual Meetings, the Vincentian authorities had contacted the Department of Statistics, and a mission to assess the need for technical assistance in that area was planned for 1993.

Capacity did limit the tourism sector, but only temporarily, the staff representative from the Western Hemisphere said. The current capacity was 800 beds, and investment was going forward to increase that capacity. The main constraint over the medium term was the islands' ecology. The islands were too small and fragile to accommodate massive tourism; in any event, St. Vincent did not have an airport suited for large international carriers.

The Chairman made the following summing up:

Executive Directors were in general agreement with the thrust of the staff appraisal. They observed that St. Vincent's overall performance had been satisfactory, with high rates of economic growth, virtual equilibrium in the balance of payments, and low inflation. These favorable developments were attributed to the prudent policies implemented by the authorities, in particular the high levels of public sector savings. At the same time, Directors expressed concern over the medium-term sustainability of this performance in view of the dependence on banana production and the uncertainty regarding the extent of preferential access for that product to the European market after 1992 as well as of the structural obstacles to diversification.

Directors noted that the uncertain outlook for the medium term required the authorities to pay particular attention to policies that would reduce costs and improve productivity in the banana and other sectors of the economy. In view of this, and given the fixed exchange rate arrangement in the Eastern Caribbean, of which St. Vincent is part, Directors stressed the importance of the authorities taking the lead by restraining the growth of wages in the public sector.

Directors expressed support for the authorities' strategy of broadening and diversifying the productive base of the economy and of undertaking investments in infrastructure to support the growth

of agriculture and tourism, which offer the most promising prospects for employment creation and foreign exchange earnings. In this regard, Directors also recommended that the authorities reassess their overall trade policy in the context of the forthcoming review of the level of CARICOM's common external tariff.

Directors commended the authorities for their commitment to maintaining a strong fiscal stance, which made possible a high level of capital expenditure without recourse to domestic financing. They supported the authorities' efforts to strengthen the revenue base of the public sector and encouraged the review of the structure of taxes and of tax administration arrangements. Directors also encouraged the authorities to strengthen the economy's statistical base.

It is expected that the next Article IV consultation with St. Vincent and the Grenadines will be held on a 24-month cycle.

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LEO VAN HOUTVEN
Secretary