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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/7

10:00 a.m., January 27, 1989

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	R. Comotto, Temporary
	J. Heywood, Temporary
	C. J. Jarvis, Temporary
	Yang J., Temporary
	D. C. Templeman, Temporary
J. de Groote	
E. T. El Kogali	
	M. Hepp, Temporary
	G. Montiel, Temporary
	C. Schioppa, Temporary
M. Finaish	
	M. A. Hammoudi, Temporary
	K.-H. Kleine, Temporary
	S. P. Shrestha, Temporary
	A. Vasudevan, Temporary
	J. E. Zeas, Temporary
	D. McCormack
	K. Kpetigo, Temporary
	B. R. Fuleihan, Temporary
	M. Pétursson, Temporary
	G. Pineau, Temporary
G. A. Posthumus	
	C.-Y. Lim
	T. Morita, Temporary

C. Brachet, Deputy Secretary
L. Collier, Assistant

Also Present

IBRD: J. B. Sokol, Latin America and the Caribbean Regional Office. African Department: G. E. Gondwe, Deputy Director. Asian Department: H. Neiss, Deputy Director; W. G. L. Evers, R. Hemming, M. Ishihara, R. Kibria, H. C. Kim, L. Nielsen, S. M. Schadler, S. Shah, W. M. Tilakaratna. Central Banking Department: T. J. T. Baliño. Exchange and Trade Relations Department: H. B. Junz, Deputy Director; A. Basu, E. Brau. Legal Department: P. L. Francotte, J. K. Oh. Western Hemisphere Department: J.-P. Amselle, S. Kawar, R. Kibuka, C. M. Loser, K. Thugge. Advisors to Executive Directors: M. B. Chatah, M. Eran, P. Gorjestani, S. M. Hassan. Assistants to Executive Directors: H. S. Binay, S. K. Fayyad, A. Hashim, C. L. Haynes, L. Hubloue, P. Kapetanovic, N. Morshed, L. M. Piantini, A. Rieffel, G. Serre, M. J. Shaffrey.

1. ANTIGUA AND BARBUDA - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Antigua and Barbuda (SM/88/275, 12/20/88). They also had before them a background paper on recent economic developments in Antigua and Barbuda (SM/88/280, 12/29/88).

Mr. McCormack made the following statement:

My authorities are in broad agreement with the staff's appraisal. Since the previous consultation with Antigua and Barbuda (EBM/87/165, 12/4/87), the economy on the whole has continued to perform satisfactorily. Real GDP is estimated to have grown by some 6 percent in 1988, fueled by continued expansion in tourism. Unemployment is very low, and, indeed, labor shortages are being experienced in certain sectors. Reflecting the conclusion of major investment projects, the current account deficit of the balance of payments was reduced sharply. The only qualification to this generally favorable picture concerns inflation; consumer prices rose by some 7 percent in 1988, mainly as a result of the behavior of import prices but also because of domestic inflationary pressures.

The authorities intend to ensure that a rapid pace of economic expansion is maintained while emerging inflationary tensions are brought under control. To this end, controls on immigration have been liberalized to facilitate an inflow of foreign labor into sectors such as construction and tourism. This policy has met with some success and will be continued in the interest of maintaining competitiveness and ensuring that rapid growth will not be choked off by labor shortages. Moreover, after the expiration of the current agreement, the authorities intend not to repeat the relatively large public sector wage awards granted in 1987. The 1987 award was, in many respects, a one-off correction to stem prospective losses of skilled manpower from areas such as education and health services.

In a small economy such as that of Antigua and Barbuda, it can be misleading to focus on year-to-year changes that can be distorted by large-scale developments of a one-off character, such as the timing of major investment projects. Viewed from a more medium-term perspective, the years 1988 and 1989 may represent something of a watershed. Hitherto, the Government's development strategy, in the absence of a sufficient domestic entrepreneurial response, had called for the State to take the lead in creating infrastructure for long-term development and, if necessary, to involve itself in commercial-type projects. This approach has, by and large, been vindicated by results.

Having set the dynamic of development in motion, the authorities are now prepared to disengage from direct involvement in economic activity and to encourage a larger role for the private sector. This new direction of policy is indicated by the proposed sale of government assets and also by the measures adopted to encourage foreign investment, including tax holidays, full repatriation of profits, and duty-free imports of materials and equipment.

The substantially reduced public sector role envisaged over the coming years is highlighted in the staff's medium-term scenarios, which project increasing public sector savings over the next five years. Reflecting lower levels of public investment, the consolidated public sector balance, at present a deficit of 5 percent of GDP, is expected to turn to surplus in 1990 and to record increasing surpluses in each year thereafter. A similarly improving trend is indicated by the balance of payments projections. There will, however, be a continuing financing gap in the years through 1993, although the size of this gap will fall in each of the years between 1989 and 1993. Thus, there is every prospect of an autonomous improvement in the country's financial position over the medium term, although my authorities readily concede that more needs to be done in the light of the high level of external debt, including arrears.

My authorities assign the highest priority to the clearance of arrears, and, to this end, a number of measures have already been taken and others are planned. The Government recently reached agreement with one of the main creditors of the public utilities corporation to reschedule a large short-term loan. Encouraged by the success of this effort, the authorities are anxious to pursue similar negotiations with other creditors. In addition, with the assistance of a British merchant bank, the Government continues to seek agreement with its major official creditors. Progress on this front has been very slow. While initial discussions had focused mainly on export credit loans, a global rescheduling is now being sought and the relevant government memorandum is being updated. However, the greatest impact on reducing the financing gap and the stock of arrears will come from the sale of two government-owned hotels. Offers are being considered that are expected to yield significant sums. The authorities wish to confirm that the proceeds from the sale of these assets will be earmarked for repayment of debt.

My authorities recognize that asset sales and similar measures to clear arrears represent one-off efforts. In the longer run, a considerably strengthened fiscal performance is needed. Regarding revenue, the authorities have increased utility rates, although they were obliged to reduce the original scale of charges to cope with special factors. It is hoped to reinstate the rollback of charges when circumstances permit. Moreover, the authorities are considering a wide range of measures, proposed by a Fund technical assistance mission, that are designed to strengthen the tax system, including tax administration. It is envisaged that the principal measures recommended by the Fund could be introduced following the forthcoming elections. With respect to expenditure, the authorities are determined to ensure that tight control is maintained over increases in the public sector wage bill. They are also committed to keeping increases in expenditures on goods and services within narrow limits over the medium term; no increase is projected for 1989. There will also be a much reduced level of public capital expenditures over the next several years.

The economy of Antigua and Barbuda, having grown rapidly in recent years, is now at a turning point. The public sector is standing aside somewhat and allowing a much larger role to be played by the private sector. My authorities are keenly aware that central to the achievement of growth with stability in the long term will be the early and orderly regularization of relations with creditors. Moreover, they agree with the staff on the need to strengthen public finances significantly in order to create a viable balance of payments position over the medium term. They have expressed their determination to take resolute action on both fronts, and they are confident that, on this basis, Antigua and Barbuda can maintain the dynamic of economic growth based largely on the private sector.

Mr. Jarvis made the following statement:

At first sight, the Antigua economy appears to be doing very well, with continued strong growth--largely owing to increased tourism-related activities--and low unemployment. However, closer examination reveals a more troubling picture. The authorities have staked a great deal on borrowing from abroad to increase tourist capacity and to improve the infrastructure. Their debt service obligations are substantial, and their ability to meet them will depend to a large extent on the success of recent investments. However, reservations expressed by the World Bank and others about the quality of some of these investments seem to have been well grounded, and notwithstanding the growth in GDP last year, the Antigua authorities were unable to fully service their debt. Consequently, further arrears have built up.

A more basic potential problem for the authorities is the continued heavy dependence of the economy on tourism. Gross receipts from this sector now amount to more than 70 percent of GDP, and the authorities believe that tourism is likely to continue to be the main engine of growth for the foreseeable future. No other island in the Eastern Caribbean is as dependent on tourism as Antigua and Barbuda, and this reliance is risky for a number of reasons.

The continued rise in tourism in the Eastern Caribbean is heavily dependent on continued growth of real income in industrial countries, especially in the United States, and on the availability of relatively cheap air transport, which is greatly influenced by oil prices. With industrial countries currently experiencing a boom in consumer spending and with oil prices currently low, it is understandable that the growth of tourism in the Caribbean has been extremely strong. However, this growth, and indeed the maintenance of current levels of tourist activity, may be very vulnerable to either a recession or an increase in oil prices, neither of which can be ruled out in the medium term. The assumption of continued growth in tourism may therefore be overoptimistic, and the authorities need to consider the implications of this possibility carefully.

The growth of income from tourism in the Caribbean islands has also depended on tourist demand being high relative to the island's capacity, but Antigua and Barbuda and other islands have been increasing their capacity in recent years. If tourist demand were to fall even slightly, excess capacity in the Caribbean tourist industry might well emerge. This would probably result in a lowering of prices, a fall in income from tourism, and the emergence of unemployment.

This problem is particularly relevant for Antigua and Barbuda. The working paper prepared last year on tourism in East Caribbean countries (WP/88/83, 9/6/88) reveals a trend that is rather disturbing for Antigua and Barbuda: that not only the absolute number of tourists, but also the country's share of tourists within the Eastern Caribbean, declines in recessions. This is particularly true of cruise ship arrivals. The authorities, therefore, would do well to consider the risk of overcapacity and the increased competitiveness between islands that would probably result. Since the islands do not pursue an independent monetary policy, control of wages is thus particularly important.

The question then arises of what the authorities can do to address these problems. I agree with the staff that control of public sector wages is important, especially as these wages are likely to influence those in the private sector, and hence Antigua and Barbuda's competitive position. I welcome the authorities' intention to limit increases in the government wage bill to no more than 5 percent a year for the next few years and to keep other expenditures under control, and I would stress the importance of their adhering to this policy. I also commend the authorities on their liberal policy with respect to the inflow of foreign labor, which has done much to ease the labor market, and I urge them to continue this policy.

More generally, the authorities should consider ways in which they can diversify development and reduce the public sector's exposure to the risks I have described. The planned sale of two government-owned hotels is an important first step in this direction, and I hope that the authorities follow through on their intention to sell part of the utilities company. They are currently considering selling 49 percent of the shares in the company; there might be considerable advantages to selling a majority shareholding--enabling them to reap the full benefits of privatization and probably making the shareholding more valuable to a potential purchaser. Any concerns that the authorities have about loss of control over pricing could then be addressed by the setting up of an appropriate regulatory framework, the terms of which could be negotiated with a potential purchaser beforehand. At present, the utilities company seems to be a classic example of a basically sound investment that has been rendered unsound by a political decision to keep prices artificially low. The financial drain is obvious and, given the current fiscal position, one the authorities can ill afford.

Further steps in diversification and risk spreading could also be initiated. The Government's encouragement of domestic agriculture is welcome, and perhaps more could be done in this area. Within the tourism sector, it might be helpful to encourage the development and sale of time-share condominiums and villas. This would have the advantage of encouraging long-term tourist demand that is likely to be less susceptible to changes in incomes and in oil prices.

The staff report refers several times to planned fiscal reforms, but no details are given. I wonder whether fiscal policy could be used to encourage diversification, and I would be interested in the staff's views.

Of particular concern is the buildup in arrears over the past couple of years. Debt service obligations in the short term are perhaps artificially heavy, because of the short-term nature of some of the finance. Even so, it is worrying that the authorities are falling into arrears on their external payments at a time when GDP is growing so rapidly. Reducing the debt by sales of assets that can be managed more productively in the private sector is clearly one way of dealing with this problem, but I think the authorities also need to plan their finances better. Indeed, perhaps there would be a case for technical assistance from the Fund in this respect. A certain amount of rescheduling or refinancing appears to be necessary. However, I urge the authorities not to attempt to defer too much of the burden to the future, as the economy is currently in a strong position and the need for rescheduling might be greater later if the economy turns down. The risk of this downturn also puts a particular premium on establishing good relations with creditors, and allowing arrears to build up at the moment could be dangerously shortsighted.

At the conclusion of the 1987 Article IV consultation, the Board drew attention to a number of the same problems that I have mentioned today. These problems have not been fully addressed in the interim, but Antigua and Barbuda has nevertheless enjoyed continued growth and economic success, and the authorities must be tempted to believe that everything is all right. In the short term, they may be correct, but the recent history of tourism in the Eastern Caribbean shows that while the long-term pattern of growth is encouraging, there is likely to be considerable volatility. The Antigua authorities must be in a good position to deal with this volatility when it arises if the economy is not to be derailed from a path of long-term growth. For this reason, I urge the authorities to consider carefully the staff's appraisal and the comments of Directors.

Mr. Lim made the following statement:

The outlook for Antigua and Barbuda appears more promising than at the time of the previous Article IV consultation discussion (EBM/87/165). Although the accumulation of external arrears--one of the most pressing problems confronting the authorities--increased substantially as a proportion of GDP in 1988, the authorities now appear to be taking the first steps toward reducing, and rescheduling, Antigua and Barbuda's external debt.

The establishment of a more orderly debt situation will greatly assist in strengthening Antigua and Barbuda's public finances, and I welcome the indication given by Mr. McCormack that the authorities assign the highest priority to the clearance of arrears. However, given the projected financing gaps, more needs to be done to improve the public sector's ability to service its debt, and in this regard I urge the authorities to adopt the revenue package recommended by the Fund's technical assistance mission and to maintain tight control over other expenditures, particularly wages in view of the large increases awarded to civil servants in recent years. Therefore, while welcoming the prospective sale of two government-owned hotels and the impact this will have on the financing gap and the stock of arrears, I agree with the authorities that these and similar measures are one-off efforts and that a long-term effort aimed at strengthening fiscal performance is needed.

Although it has had to deal with these problems, Antigua and Barbuda has enjoyed high rates of growth in recent years with low unemployment. Growth rates are expected to decline gradually to 5 percent over the period of the staff's projections, but this will be an acceptable price to pay if order can be restored to public finances and the external debt situation.

In light of the Government's recent experience with direct involvement in the construction of hotels and other projects, I welcome its decision to leave the future development of tourist accommodation to the private sector, and to remove itself from direct involvement in economic activity in general. Given the apparent strength of the tourism sector in Antigua and Barbuda--and the weakness of public finances--I wonder whether the Government needed to provide incentives for investment in this sector of the economy. However, the authorities' moves to improve air access to the islands and provide training for local personnel in tourism-related skills should pay dividends in both the short and longer term.

At the time of the 1987 Article IV consultation, Directors expressed concern about the effect of rapid wage increases on competitiveness. In the event, the continued strong growth in tourism--the mainstay of the economy--appears to have enabled these increases to be passed on without apparent ill effect. However, this will not always be the case, and it is vital that wage increases not affect Antigua and Barbuda's competitiveness.

In sum, if the authorities take the actions needed to strengthen public finances and if they can both reduce and restructure Antigua and Barbuda's public debt, the basic structure of the economy will be much improved. The implementation of these measures, when coupled with the promising outlook for tourism, would bode well for the economy.

Mr. Templeman made the following statement:

Data on economic performance in Antigua and Barbuda reveal a mixed performance in recent years. Real economic growth, fed by the expanding tourist industry and supporting construction, has been impressive. This has had positive effects on employment and has not led to intolerable inflationary pressures. Building on the islands' comparative advantage in tourism has been logical and successful, although attention to economic diversification is clearly merited.

What is unfortunate about past economic performance, however, is the way in which growth has been financed, as reflected in extremely large fiscal and current account deficits and large external arrears. The brief comment in the staff report citing the rather critical attitude of the World Bank concerning the past selection of public investment projects and the terms of the foreign credit obtained to finance them is revealing. Evidently most of these public investments have now been completed or are nearing completion. We hope, however, that great prudence will be exercised in selecting any remaining future public investments.

In the meantime, the bulge in domestic and external imbalances is receding. Still, there is a major job to be done in continuing to reduce these imbalances and in regularizing the islands' relationship with foreign creditors. Since the investment boom was concentrated in the public sector, important fiscal adjustments are now required. On the revenue side, we are pleased to see that implementation of some of the Fund's technical assistance proposals for new revenue measures could be effected after the elections. The partial rollback of the recent utility rate increase also needs to be reversed as soon as possible. On the expenditure side, the large public wage increases allowed for in 1987-89 under the current wage agreement have built into the system some upward pressures that could contribute further to price acceleration. We welcome Mr. McCormack's assurance that such large wage awards will not be repeated. Also, the scaling back of public investment should contribute significantly to a decline in the fiscal deficit.

To some extent, tightness in the labor market resulting from rapid economic growth is a sign of success. But shortages of skilled labor need to be addressed--and are being to some extent already--by training programs and by continuing a flexible policy with regard to immigration of labor from neighboring islands. Also, I hope that the labor market will be flexible enough to allow some movement of workers from the public sector to the private sector as the public investment program winds down.

Antigua and Barbuda has benefited from a steady improvement in the terms of trade, mainly owing to larger increases in hotel rates than in import prices. However, this could be a double-edged sword, in light of the rather strong competition among Caribbean islands for tourist income. The related modest real effective appreciation of the Eastern Caribbean dollar in 1988 underlines the importance of monitoring closely the country's competitive position.

We welcome the staff's preparation of medium-term fiscal and balance of payments projections. Perhaps, if such an exercise had been carefully prepared several years ago, the domestic and external imbalances and foreign arrears that emerged in recent years might have been avoided. Because of the importance of the public sector in international transactions, there is a degree of parallelism in the outlook for these imbalances, although large current account deficits are expected to persist longer than fiscal deficits. In both cases, substantial financing gaps are revealed, for which clear sources of financing are not identified. On the one hand, planned sales of publicly owned hotels and new revenue measures have not been assumed. On the other hand, regularization of the islands' large arrears on external public debt is not explicitly provided for. While presentation of potential financing gaps is useful in alerting the authorities to the size of the problems ahead, it would also be helpful to be able to foresee more clearly how these gaps will ultimately be filled. In any case, we urge the authorities to move promptly to regularize their relationships with their external creditors. In that connection, we wonder whether the reference by Mr. McCormack to a possible global rescheduling refers to a multilateral official rescheduling.

While we would normally consider Antigua and Barbuda to be a potential candidate for the bicyclic consultation procedure, we agree that the size of its continuing economic imbalances, including its external arrears, merits its retention on the standard 12-month cycle.

Mr. Zeas made the following statement:

During 1988, the Antigua economy experienced a significant rate of growth in real GDP for the sixth consecutive year. Tourism seems to be responding well to the authorities' efforts to provide appropriate hotel capacity and other related infrastructure. According to the staff report, hotel capacity is no longer a problem, and we agree with the view that the authorities may need to concentrate their efforts on obtaining more frequent flights by interested international airlines.

Most of the growth in real GDP originated in the tourism and public construction sectors, while performance in the agricultural and manufacturing sectors was moderate. This indicates that there may be room to promote agriculture to complement the tourist industry and reduce food imports, for example. The boom in public sector construction was accompanied by a tightening of the labor supply of this small island economy of only 83,000 residents. Unfortunately, the wage increases granted were in excess of inflation rates, in both 1987 and 1988, and contributed to the deterioration of public sector finances, making it impossible again in 1988 for many state enterprises to service their foreign debt obligations. Thus, debt arrears continued to accumulate in 1988, reaching US$68 million, equivalent to 21 percent of GDP, while the stock of debt rose to the equivalent of over 80 percent of GDP, compared with only 33 percent five years ago.

As the Antigua economy faced similar problems in the recent past, and in view of Mr. McCormack's statement, it is clear that the authorities are aware of the problems and of the solutions necessary to reverse this deterioration. We urge the next Administration, which will take office after the 1989 elections, to act upon the recommendations made by the staff, in particular, to moderate public sector expenditure, implement tax and administrative reforms, and increase public utility tariffs. On this last subject, important progress was made in 1988, but we encourage the authorities to maintain utility tariffs, in real terms, in the period ahead. Furthermore, because the tax effort is already equivalent to 22 percent of GDP, we recommend placing more emphasis on expenditure reduction than on additional tax increases.

Having reached a per capita income of close to US$3,800, the authorities should now aim at striking a better balance between further growth, debt, and stability. If the authorities do not act decisively on the fiscal front, they will be pressured, sooner than they would like, into selling more of the recently built hotels, villas, and condominiums to be able to pay debt arrears.

In this connection, given the relatively short maturity of the commercial debt obligations--which account for about 74 percent of total debt--and the high interest costs and commissions involved, one possible option for the authorities could be to seek a debt refinancing agreement. The recent agreement reached with one of the main creditors, as mentioned by Mr. McCormack, is an important step. A Fund program could play a helpful role by providing more credibility to the authorities' policies in these negotiations.

Because of the need to promote private investment, the authorities have announced a package of measures, including tax holidays, duty-free imports, and full repatriation of profits for foreign investors. We wonder whether potential domestic investors have been put at a disadvantage and whether these tax incentives are similar to those granted elsewhere in the Caribbean; we would appreciate clarification from the staff or Mr. McCormack.

Mr. Posthumus said that in general he supported the staff appraisal. The remarks made by his chair during the previous Article IV consultation discussion on Antigua and Barbuda (EBM/87/165, 12/4/87) remained valid, particularly the comments on the external deficit and arrears situation, wage policy in the public sector, and the strategy with respect to stimulating investment in the tourism sector.

The World Bank had doubts, also reflected in the staff appraisal, about Antigua and Barbuda's fiscal and financial policies, Mr. Posthumus noted. Moreover, the Bank had expressed reservations about some of the projects selected by the authorities. Considering the profound impact on the country's economic future and external financial relations of public sector investment policy, the Fund should advise the authorities to involve the World Bank in their policymaking and perhaps even in financing. While the authorities intended to rely on the private sector exclusively for the development of additional tourist accommodations, the incentives that they intended to provide were lavish; in particular, tax holidays of 10-15 years seemed long.

Wage policy in the public sector seemed more satisfactory as far as intentions were concerned, Mr. Posthumus remarked. However, an annual increase in the government wage bill to 5 percent seemed rather large, from the point of view of both the budget and the competitive position of the islands.

Although during the 1987 consultation discussion Directors had recommended the regularization of arrears, the outstanding amount of arrears had apparently increased by 50 percent in 1988, Mr. Posthumus observed. The staff appraisal could have been more critical of that situation. Moreover, the average maturity of outstanding debt had been decreasing over the past few years, indicating a continued difficult debt situation.

In general, if in a period of increasing demand for a country's products--in the present case tourism--the financial situation of both the fiscal and external sectors did not improve, then great risks could arise if demand slackened, a movement that could occur in the tourism sector, Mr. Posthumus concluded.

The staff representative from the Western Hemisphere Department remarked that to foster diversification in Antigua and Barbuda, which had a limited resource base, the authorities were considering the role of fiscal reform. Tax holidays, which applied not only to foreigners but to domestic investors as well, were aimed at promoting development of both the tourism sector and the manufacturing sector--particularly of industries using assembly-line processes. However, with the strong growth in tourism, interest in manufacturing was limited at the present stage. In the agricultural sector, the Government had attempted to promote production of commodities that would serve the tourism sector, although agriculture would be affected by developments in tourism. The authorities' general strategy focused on the use of contract labor, given the scarcity of labor in the economy, with the idea that if a recession should occur, particularly in tourism, the contract labor would leave the country to be replaced gradually by domestic labor as needed.

To develop the necessary infrastructure and hotels rapidly in order to profit from the tourist boom of the 1980s, the authorities had relied on short-term financing, the staff representative said. Consequently, the authorities were anxious to sell the hotels; they had no intention of participating directly in the hotel business or of seeking refinancing. During the discussions with the staff, the authorities had expressed confidence that the hotels could be liquidated on reasonable terms; reducing the debt related to hotels would go a long way toward eliminating the existing stock of arrears.

The authorities were favorably inclined to consider selling 49 percent of the shares of the utilities company, the staff representative from the Western Hemisphere Department noted. However, because of the upcoming elections, there was some sensitivity to surrendering fully the ownership of the utilities company, which encompassed electricity, water, and telephone service. The issue would probably be addressed at a later stage of negotiations.

Mr. McCormack remarked that a central theme of the discussion was the vulnerability of the Antigua economy because of its dependence on tourism. Within the existing narrow operational constraints, the authorities were trying to diversify the economy to the extent possible. Of course, the country had a comparative advantage in tourism, which the authorities naturally wished, as a long-term objective, to exploit as fully as possible. The promotion of time-sharing and similar devices was a useful suggestion in that connection.

On the question of arrears, first, in the short run the authorities envisaged a major impact from the sale of the two government-owned hotels, and they could confirm that offers had been received, Mr. McCormack said. Second, the authorities were using the offices of a British merchant bank to talk to creditors individually on the basis of a joint memorandum that had been presented to each of them; therefore, although formally it was not a multilateral rescheduling, in practice, it was similar as the authorities were offering uniformity of treatment. While his authorities did not envisage the need to involve the Fund on a formal basis by undertaking a program, they appreciated and benefited from regular Article IV consultation discussions and, therefore, were anxious to retain the standard 12-month cycle.

The authorities understood the need to strengthen public finances for example, as had been suggested, by selecting projects more carefully, Mr. McCormack commented. In fact, the authorities had begun to revamp the Projects Unit in the Ministry of Economic Development, Tourism, and Energy and were making other efforts in that direction.

Diversification was a difficult objective that would require time and effort, Mr. McCormack observed. For instance, the climate in Antigua and Barbuda was not conducive to large-scale agricultural development requiring water, and such projects would have to wait until a desalinization process was available. The authorities had been imaginative in the area of diversification, but it would take time, and the economy would thus remain dependent on tourism for the foreseeable future.

The Acting Chairman made the following summing up:

Executive Directors were in general agreement with the thrust of the staff appraisal. They noted that economic growth in Antigua and Barbuda was among the highest in the Caribbean and that unemployment was very low; at the same time, prices had tended to accelerate in the past two years, and there had been sizable real wage increases reflecting, in part, labor shortages.

Directors noted that since Antigua and Barbuda's previous Article IV consultation with the Fund, public sector savings had declined markedly because of the rollback in electricity rates and the sizable increase in pay to civil servants. They observed that despite a significant improvement in the overall public sector position, external arrears had continued to accumulate. Directors, therefore, commended the authorities' intention to sell two government-owned hotels and their consideration of divesting the utilities company, and they recommended that these operations be concluded as soon as possible to reduce arrears. Speakers welcomed the recent successful rescheduling of a large commercial loan and stressed the importance of continuing negotiations to reschedule the remaining short-term commercial obligations, including those currently in arrears.

Directors urged the authorities to complement these measures by strong, long-lasting fiscal action to raise revenue and restrain expenditure in order to avoid the recurrence of arrears. To this end they welcomed the Government's intentions, as soon as possible, to increase substantially electricity rates and to implement the main recommendations on revenue of the recent technical assistance mission from the Fund. It was noted that revenue as a percent of GDP is relatively high, and it was suggested that emphasis should be placed on expenditure control. In this regard, speakers emphasized the importance of limiting future wage increases so as to strengthen the public finances and the balance of payments, in view of the real effective appreciation of Antigua and Barbuda's currency that had occurred recently and the tight labor market conditions prevailing. Directors observed that continuation of the authorities' liberal policy on immigration would be helpful in mitigating labor market pressures.

Directors commented on the heavy dependence of the economy on tourism and thus its vulnerability to real income changes in industrial countries and to oil price movements. They stressed the importance of diversifying the productive base, including agriculture and manufacturing, if economically feasible; of encouraging private initiative; and of applying stricter criteria of efficiency to public investment decisions than had been the case in the recent past. At the same time, measures--such as encouragement of time-sharing--could perhaps be taken to make tourist arrivals and income from tourism more stable and predictable.

Given Antigua and Barbuda's difficult fiscal situation, which includes the existence of large external arrears, it is recommended that, as requested by the authorities, the next Article IV consultation be held on the standard 12-month cycle.

2. FIJI - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Fiji (SM/89/1, 1/3/89; and Sup. 1, 1/26/89). They also had before them a background paper on recent economic developments in Fiji (SM/89/9, 1/13/89).

Mr. Shrestha made the following statement:

My authorities in Fiji are in broad agreement with the staff's analysis of the developments and prospects for the Fiji economy and with the recommended two-year Article IV consultation cycle.

In 1987-88, the Fiji economy was struck by the worst drought of the century, causing severe damage to the sugar crop in both years. The tourism sector, meanwhile, was affected temporarily by political changes that took place in 1987. As sugar production and tourism form the two most important contributors to output growth, real GDP fell by 8 percent in 1987 and by a further 2 percent in 1988. Inflation, which was virtually stable in 1986, increased from mid-1987 under the impact of the two devaluations of the Fiji dollar. Nevertheless, the effect of the devaluations on the economy was cushioned by the stringent measures adopted by the authorities to dampen domestic demand. In 1988, the effect of the devaluations was felt more, with the inflation rate rising to 12 percent year-on-year to September 1988 from 5.7 percent in 1987 as a whole. The unemployment situation deteriorated with most of the loss in employment recorded as the result of a slowdown in the tourism and construction sectors.

In 1987, lower earnings from tourism and the large transfers abroad associated with emigration were almost offset by the sale of sugar from stocks, a sharp increase in other exports, and a decline in imports. As a result, the current account surplus of the balance of payments remained unchanged at US$7 million, or 1 percent of GDP. However, owing to short-term capital outflows and a bunching of official debt repayments, the overall balance of payments recorded a deficit of US$30 million.

In 1988, the surplus on the current account increased to an estimated US$45 million, or 4 percent of GDP, brought about by continued sales from sugar stocks, a further favorable increase in other exports, and a reduction in transfers associated with emigration. With capital inflows returning to normal levels, the overall balance of payments registered a surplus of US$65 million. Gross official reserves at the end of 1988 are estimated at US$195 million, or seven months of imports.

Following the political changes in May 1987, emigration of Fijians of Indian origin surged, resulting in large outflows, and capital flight occurred in anticipation of a devaluation. At the same time, real output growth was adversely affected by the drought and the reduction in tourist arrivals. These developments prompted the authorities to introduce restrictions on capital transfers abroad, devalue the Fiji dollar, and tighten fiscal and monetary policies, in an effort to prevent a rapid depletion of foreign exchange reserves and a sharp fall in government revenue.

The Fiji dollar was devalued by 17.75 percent on June 29 and by 19.25 percent on October 7, as part of the authorities' efforts to stem the outflow of capital. The authorities also prohibited capital transfers abroad other than for inheritances, dowries, or transactions in fulfillment of a legal obligation. To provide for better monitoring of capital transactions, limits were imposed on purchases of foreign exchange for certain current transactions from authorized dealers, beyond which the approval of the Reserve Bank must be sought.

A principal objective of the 1987 budget was to lower the overall deficit through revenue measures. However, an expected fall in revenue arising from a weakened economic environment prompted the authorities to implement expenditure-cutting measures. These included a cut in the wages and salaries in the civil service, the halving of undisbursed grants and transfers, and the imposition of limits on expenditures on goods and supplies, especially for education and general supplies. Some low-priority projects were postponed. In 1988, sharp cuts in current expenditures were also undertaken. Allocations for discretionary current expenditures--wages and salaries, subsidies, nonpension transfers, and purchases of goods and services--were reduced by 30 percent across the board from the 1987 budgeted level. Some new projects were deferred, and net lending to public enterprises was reduced. In midyear, there were indications that domestic revenues would be higher than expected. In response to this development and the resumption of foreign aid disbursements, the Government requested additional expenditure appropriations, mainly for salaries and capital projects.

At the start of 1987, economic and monetary conditions were favorable for a continuation of a relaxed monetary policy stance in support of economic growth; however, monetary conditions changed significantly in midyear. A sharp decline in foreign reserves, accompanied by a surge in credit expansion, caused a severe drain on bank liquidity. In response, the authorities adopted various measures to stem the outflow of reserves and to contain credit expansion. These measures included an increase in the Reserve Bank's minimum lending rate from 8 percent to 9 percent, the discontinuation of the automatic access of commercial banks to the Reserve Bank's rediscount facility, and a removal of controls on interest rates. In September, the Reserve Bank adopted additional credit control measures, which included suspension of the export finance facilities and further increases in its minimum lending rate. These measures helped to slow down private sector credit expansion from a year-on-year rate of 25 percent in September 1987 to 7 percent in December 1987. In 1988, the authorities continued policies aimed at protecting official reserves and retained most monetary control measures they had adopted after May 1987.

With adequate rainfall in 1988 and with significantly higher advance bookings, both sugar production and tourism are expected to recover to their pre-1987 levels. The forestry, fishing, and garment manufacturing sectors are also projected to perform favorably. Real GDP is expected to increase by 7-8 percent. As import demand is forecast to remain relatively weak, the current account of the balance of payments is likely to record a surplus of about 4 percent of GDP. The surplus on the overall balance of payments is estimated at US$84 million and reserves at the equivalent of about nine months of imports at the end of the year.

The balance of payments outlook beyond 1989 depends very much on developments in tourism and on domestic business confidence. Assuming an improvement in the tourism sector and the return of business confidence, consumption and investment are expected to increase. Nontraditional exports are projected to continue to expand rapidly.

As imports are projected to grow, induced by higher domestic demand, the current account of the balance of payments will reverse to a deficit in 1990. However, a surplus on the current account could be achieved in 1991, if favorable performances by the export and tourism sectors continue and if import demand levels off. In both 1990 and 1991, the overall balance of payments is expected to remain in surplus, with large inflows of private capital, particularly for investment in the tourist industry.

In an effort to promote more rapid and outward-looking development of the manufacturing sector, the authorities established a Tax Free Zone in early 1988. Under this arrangement, companies that export 95 percent of their production can enjoy a tax holiday of up to 13 years, duty-free imports, and freedom from government regulations, including wage and price controls. The authorities also intend to eliminate, within the next 3 years, all preferential treatment of import-substituting industries. Quantitative import restrictions will be abolished, and a more uniform tariff structure will be introduced.

The tripartite system of wage negotiation was suspended after the political events of 1987, and a wage freeze was introduced in early 1988. The authorities maintain price controls on a number of commodities and services, and these controls are administered flexibly, thus discouraging hoarding and the emergence of a parallel market.

The 1989 budget was presented to the Cabinet on December 14, 1988, with estimated increases in both revenues and expenditures. With the full restoration of the earnings of civil servants from January 1, 1989, wages and salaries are budgeted at 54 percent of current expenditures, an increase of 20 percent over 1988. Other current expenditures will be kept at about the 1988 levels. Capital expenditures are budgeted to increase by over 30 percent, with one third of the total being allocated to infrastructure. Revenues will benefit mainly from increases in receipts from customs duties and from new revenue measures.

With the recovery in tourism and sugar exports, both foreign reserves and broad money are expected to rise rapidly in 1989. The increase in broad money will add to the already excessive liquidity in the economy. To absorb bank liquidity, the staff suggested that the authorities consider the more flexible instrument of selling treasury bills, rather than raising reserve requirements or requiring banks to place special deposits. To this end, the existing ceiling on the issuance of treasury bills will have to be raised or, if that is not possible, the Reserve Bank may issue its own paper. The authorities are receptive to these suggestions and have since asked the Fund for assistance in working out the technical details, and a Fund mission is slated to visit Fiji next month.

The authorities expect the rate of emigration to slow down in 1989. Therefore, some relaxation of the restrictions on capital transfers abroad were announced in the 1989 budget speech.

The authorities consider a level of foreign reserves equivalent to six months of 1988 imports as the minimum required under the present circumstances. The authorities pointed to the need to, first, meet any contingency that might arise from the existing political situation; second, maintain international creditworthiness; third, monitor the low level of current imports, which made the reserve ratio artificially high; fourth, finance a large increase in imports once business confidence returns; and fifth, accommodate a large outflow after restrictions on capital transactions are lifted.

On the exchange rate, the authorities recognize that the devaluations in 1987 have helped to increase competitiveness, thus providing a much needed impetus to tourism and nontraditional exports. They will refrain from revaluing the Fiji dollar when political conditions return to normal and will monitor the exchange rate closely to ensure that competitiveness remains adequate for further development of the export sector.

Mr. Heywood made the following statement:

Over the past two years, the Fiji economy has been buffeted by two major shocks, which severely depressed the country's key sugar and tourism sectors, induced large capital outflows, and led to a collapse in business confidence. Largely as a result of these factors, real output fell by more than 10 percent over the past two years, continuing the rather dismal growth performance of the economy during the 1980s and further increasing the rate of unemployment.

Despite this somewhat disappointing picture, the authorities can take some comfort in the improved outlook for 1989. It is clear that the decisive actions they took in the second half of 1987 and in 1988 have helped to stabilize the economy and to pave the way for a significant recovery in growth, a deceleration in the rate of inflation, and a further buildup in foreign exchange reserves to historically high levels. The authorities' decisions to devalue the exchange rate in 1987, to tighten fiscal policy, and to eliminate interest rate controls were both well directed and timely.

Looking to the future, the authorities will need to maintain a tight monetary and fiscal stance to keep inflationary pressures under control and to improve business confidence. In this context, we were encouraged by the broad thrust of the provisional 1989 budget, as it implied a further reduction in the fiscal deficit to 1.6 percent of GDP. However, as the supplement to the staff report explains, the final budget contained provisions for a substantial increase in the public sector wage bill. I would be interested to hear the staff's views on the timing of these wage increases, particularly in light of the level of liquidity in the economy at the present juncture.

Given an appropriately tight macroeconomic framework, the main challenge for the authorities over the short term will be to implement urgent structural reforms designed to improve the efficacy of demand-management policies and to enhance the productive potential and resilience of the economy.

On the fiscal side, the authorities should consider measures to increase the elasticity of the tax system. It is notable, for example, that over the period 1985-88, while private sector consumption rose by over one fourth, the tax yield from goods and services rose by less than one fifth. Similarly, it is surprising that despite a 33 percent devaluation of the exchange rate in 1987, import duties in domestic currency terms have remained approximately flat over the past two years. We support the staff's suggestion that the Fiscal Review Committee should consider seriously the case for introducing a general sales tax. While the revised projection for 1989 is encouraging, a further increase in the public sector savings rate would be particularly welcome in present circumstances. This would permit a sustained increase in public investment at a time when private investment continues to be held back by the current political uncertainties. The sharp fall in Fiji's aggregate investment ratio over the period 1984-88 is not consistent with a return to the 5 percent annual growth rates of the 1970s.

One issue not mentioned by the staff is the question of public enterprise reform. Over the medium term, the authorities should consider the scope for privatizing at least the Group C enterprises, which operate in a commercial environment. There would seem to be no compelling reason why the Government should own a sugar corporation, a tuna canning factory, or a wood processing plant. Perhaps a start might be made by allowing the private sector to enter the sugar crushing sector, particularly if an extension in capacity is under consideration.

In the nearer term, a number of deregulatory measures need to be implemented to free up the economy and improve its competitiveness. The recent establishment of a Tax Free Zone is welcome, as is the authorities' public commitment to a shift in policy away from import substitution toward export-oriented growth. However, as the 1989 budget recognizes, import liberalization will need to be accompanied by a thoroughgoing decentralization of the process of wage determination and by less bureaucratic pricing policies. In addition, given the fact that land availability may soon begin to constrain the productive capacity of the sugar sector, I would be interested to know whether the staff believes that a program of land reform could enhance Fiji's medium-term growth prospects as it has in certain other countries in the region.

With respect to monetary policy, the staff is right to focus attention on the substantial liquidity overhang present in the economy and on the projected rapid growth in broad money and net foreign assets in 1989. In these circumstances, as the authorities recognize, there is an urgent need to develop instruments to soak up bank liquidity, and abolition of the ceiling on treasury bill issues would appear to be the natural step.

The staff's medium-term projections assume that by 1990 there will be an improvement in Fiji's uncertain political situation. I would be interested to know what output growth projection underlies this scenario, and whether the import growth figures take into account the possible introduction of liberalization measures. In general, the balance of payments projections look reasonably comfortable. However, the authorities are aware of the downside risks; a deterioration in the political situation could lead to a further brain drain, a sustained dislocation in private sector activity, and a falloff in capital inflows.

It was encouraging to learn from Mr. Shrestha that the Fiji authorities are content with the way the bicyclic Article IV consultation procedure has worked. The staff's interim report was no doubt helpful to the authorities. Indeed, they have accepted the staff's key recommendations in the areas of import liberalization and tariff rationalization. We hope that more members will follow Fiji's example by moving to the bicyclic procedure over the coming years.

Mr. Lim made the following statement:

Three main factors have affected Fiji's recent economic performance. First, drought seriously reduced the production of sugar, Fiji's main crop; second, the deterioration in the political climate resulted in a sharp downturn in tourism, accompanied by a loss of business confidence; and third, the long-standing, pervasive government regulation of private sector activities has had ongoing adverse effects on the Fiji economy. There is little that can be said about the first two factors, although the economy's heavy reliance on sugar underlines the need for diversification of the country's economic base and the creation of conditions that will foster that diversification, while we hope that future political developments will be conducive to a return of business confidence.

Given the effect of government regulations on the economy, I welcome the focus in the report on the need to reduce regulations and to remove the distortions in production incentives. The Fiji Government has already announced its intention to eliminate some measures protecting industry--albeit over a three-year period--and to apply a more uniform tariff structure. These steps are in the right direction; however, the authorities need to take further measures aimed at freeing up the economy, along the lines of those suggested by the staff. These measures, following the improvement in competitiveness in recent years, would go a long way toward maintaining, and improving, Fiji's competitiveness in international markets. Indeed, the establishment of the Tax Free Zone (TFZ) appears to provide a graphic illustration of what can be achieved when enterprises are freed from restrictive government controls. Particularly noteworthy is the rapid increase in employment, over a very short time span, for companies with TFZ status. In view of the high level of unemployment in Fiji, it would be useful if this impetus to employment growth could be applied throughout the economy.

Although beset by low growth, the Fiji economy is in reasonable shape to undertake a liberalization program. The overall deficit of the Central Government as a percentage of GDP is expected to increase in 1989, owing mainly to capital expenditures, but it will remain well below the relatively high levels of 1986 and 1987, while the balance of payments and external debt present no pressing problems for the authorities, at least in the medium term. Again, the staff has made some useful suggestions for improving the Government's fiscal management, and I urge the authorities to consider them seriously.

In respect of monetary policy, it is vital that the authorities take action to absorb the substantial increase in liquidity expected in 1989. Selling treasury bills appears to be the most efficient way of doing so, and at the same time it will contribute to increasing the sophistication of Fiji's financial system. We hope that it will also encourage the banks to lower their lending rates; the expected sharp drop in the inflation rate in 1989 may provide some encouragement in that respect.

The outlook for the Fiji economy is favorable, provided that the political situation improves--and with it business confidence--and that the authorities are prepared to carry out the structural reforms suggested by the staff. These are important qualifications, but I urge the authorities to proceed with structural reform while maintaining prudent financial policies.

Mr. Templeman made the following statement:

During the previous Article IV consultation discussion on Fiji (EBM/87/4, 1/9/87), we joined the Board in commending the authorities for generally prudent financial policies, in suggesting greater wage flexibility, in supporting some structural reforms, and in urging a reduction in Fiji's antiexport bias. We also commended the authorities for careful management of their external position, but we expressed some concern about the need for greater diversification and job creation, and we mentioned the possible need for reforms of public enterprises.

Much has happened since that discussion, notably the severe drought and the political problems that culminated in the 1987 military coup. The adverse effects of both events can be clearly seen in Fiji's economic performance. Economic growth has been negative, the unemployment rate has risen, and inflation has accelerated. Perhaps most important, preoccupation with containing the immediate adverse economic effects of these developments has impeded the actions needed to create a more favorable environment for growth and diversification of the economy over the medium term. In some respects, economic developments have not been as bad as might have been expected, reflecting continuation of a rather prudent approach to fiscal and monetary policies, and Fiji's strengthened competitiveness, partly as a result of currency devaluations. As a consequence, the fiscal deficit is not exceptionally high--although the upward revision for 1989 is somewhat disturbing--and the balance of payments and debt situation remain relatively favorable. Of course, an undesirable slowdown in economic activity also partly explains this outcome.

The apparent recovery of sugar production and the improved outlook for tourism this year provide a degree of assurance that the worst may be over. But until political uncertainties are reduced and business confidence revives, it is hard to see how substantial progress can be made in setting the economy on the desired path of growth and diversification. The staff makes a number of suggestions that seem to us appropriate and that, evidently, have found some favor with the authorities. Among them is the need both to raise public savings and to create a broader revenue base through tax reforms. We would, like Mr. Heywood, enquire about possible reforms--and some privatization--of public enterprises. In the monetary area, we agree with the staff about the potential danger of a liquidity overhang and with the suggestion that the authorities should consider a treasury bill issue to sop up excess liquidity. But we wonder whether sales of longer-term securities, both public and private, would also be feasible.

A number of positive developments in the external accounts offer the promise of balance of payments viability over the medium term. First, the 35 percent real effective depreciation of the Fiji dollar over the past three years seems to be helping nontraditional exports. Prospects seem good for the growth of tourism, although tourists are notoriously sensitive to political instability, as has already been amply demonstrated. The danger of a renewed outflow of emigrant remittances, and of the emigrants themselves, cannot help but cast a shadow, not only over the balance of payments but over economic prospects more generally.

The expected buildup of foreign reserves this year, although partly reflecting a low level of imports because of weak domestic demand, should provide some cushion, first, to roll back as soon as possible the exchange restrictions that were introduced to avoid continued capital flight, and second, to ease the way for a more fundamental dismantling of trade restrictions. In fact, it is remarkable that a country the size of Fiji should ever have adopted a basically import-substitution strategy. Therefore, we strongly support the proposal to eliminate quantitative restrictions over the next three years and the introduction of a lower and more uniform customs tariff system. Moreover, we endorse the staff's suggestion that a clear timetable for liberalization should be formulated as soon as possible to provide a degree of certainty for the business community in making its investment plans. In that connection, the reference in Supplement 1 to a phaseout of import quotas on a number of items is not very revealing.

We also support price control deregulation, as import liberalization provides an alternative means to contain inflationary pressures. We hope that the authorities will consider a more flexible system of wage determination through collective bargaining at the enterprise level, so that wage diversification can help to promote labor mobility and economic diversification. Market incentives, rather than industrial licensing, offer the best prospects for developing competitive new industries.

Mr. Posthumus observed that political stability was important for further economic recovery and for the restoration of business confidence in Fiji. The absence of such stability or the uncertainty in that respect made it difficult to assess the situation in the country, but taking those factors into account, he could support the staff appraisal. The decline in sugar output and the sharp downturn in tourism had been met adequately by the policies of the authorities, but sustaining those policies was not in the long-term interest of the economy. In particular, efforts to diversify the economy could be successful only if the private sector was less restricted in its activities, and policies in that direction were being developed.

With respect to the exchange and trade system, the Fiji dollar was pegged to a basket of currencies representing the country's five major partners, Mr. Posthumus noted. The real effective exchange rate had declined substantially from 1985 to 1987, when two devaluations had taken place, so that in September 1988 the real effective rate had been 37 percent below its peak of March 1985. It was not clear why the devaluations had provided, as the staff indicated, a much needed impetus to tourism and nontraditional imports. Prior to 1987, inflation in Fiji had been rather low, and from that point of view a correction was not necessary. The devaluations in 1987 had been undertaken primarily as part of a concerted effort to stem the bouts of capital flight that had followed the political disruptions. However, in 1987, capital transfers abroad had been prohibited, so that the main argument for the devaluations did not apply. He wondered why the staff was concerned about the competitiveness of the export sector, and whether it considered the pegging of the Fiji dollar to the chosen basket in itself insufficient as a guide to maintaining competitiveness.

Mr. Morita made the following statement:

I generally endorse the staff appraisal. The authorities should be commended for their successful efforts to overcome, through judicious macroeconomic policies, the difficult situation resulting from the political disturbances. Tight monetary policy has kept the inflation rate under control, although domestic consumption had reached a high level owing to panic purchases, and the inflationary effects of the devaluation of the exchange rate had been felt. The austere fiscal policy also played a part in maintaining a sound balance of payments position and, with the high level of foreign reserves, helped the authorities to restore confidence abroad in the Fiji economy.

The authorities should continue the cautious fiscal and monetary policies in 1989. The current stagnant economic situation is largely due to the lack of confidence, and an expansionary policy is, at this stage, counterproductive. Rather, the authorities should focus their efforts on absorbing excess liquidity in the monetary area, which could be harmful when the situation returns to normal and domestic demand rises sharply. In this light, the avoidance of monetization of the fiscal deficit through stringent fiscal policy and the active sale of securities in the monetary market would be the proper policy mix.

On the wage issue, during the previous Article IV consultation discussion on Fiji (EBM/87/4), this chair cautioned that wage determination by a rigid formula or by a freeze might be inappropriate; wages should be determined more by the interplay of market forces of demand and supply. A freeze was reimposed in early 1988 and, as a result, real wages declined substantially. This outcome could be welcome in the sense that it helped the economy to retain international competitiveness during that period. That being said, this chair's fundamental view has not changed; the authorities should consider shifting the wage determination formula to a more market-determined basis. The timing may be appropriate now because economic activity is sluggish and the unemployment rate is high, so that fear of a sharp rise in wages because of the removal of the wage freeze would be relatively slight. In this context, we wonder whether the budgeted wage increase in 1989 correctly reflects the labor market situation.

Finally, we are interested in knowing the economic impact of the emigration of Fijians of Indian origin. The short-term impact would be reflected in capital flows, but the staff suggests that these Fijians are active in sugar cultivation, commerce, and the professions, while ethnic Fijians are active in the tourism and land-leasing sectors. Therefore, we would like to learn from the staff whether the labor market is flexible enough to cover possible labor shortages in some sectors in the future, or whether there might arise an imbalance in employment that could affect the prospects for growth of certain sectors in the economy in a medium- to long-term perspective.

The staff representative from the Asian Department said that, on the issue of privatization, the public sector in Fiji was not large compared with that in many other developing countries, and on the whole it was profitable. However, a number of enterprises were continuing to incur losses, and the Government had been addressing that problem since 1985, when it had established a public enterprise unit to determine how those enterprises could improve their performance, for example, by changing their pricing policies or otherwise increasing their efficiency. However, the unit had not been able to pursue its objectives because of the political events of 1987. Staffing had not been adequate, and the investigation had not proceeded. Nevertheless, the Government remained committed to improving the efficiency and profitability of the enterprises and was at present discussing with the World Bank the possibility of corporatization of some statutory bodies and the privatization of at least two enterprises. However, because of the political conditions and uncertainties prevailing at present, such privatizations were not considered appropriate except in a medium-term time frame. The Fund staff fully supported that objective.

Wage increases in both the private and public sectors had taken effect January 1, 1989 with the objective of restoring wages to the mid-1987 levels, the staff representative noted. To achieve that aim, wages would be raised by 11 percent in the public sector and by about the same amount in the private sector. However, taking into account the price increases that had occurred over the past 18 months, real wages would remain about 15 percent below the level of two years previously. It was worth mentioning that the Government had announced that henceforth wages in the private sector would be determined on the basis of productivity and competitiveness in international markets, which constituted a major departure from past policies.

Land in Fiji was communally owned by the indigenous people, and such ownership did not impose a restriction on development, as it did in many other countries in the Pacific, the staff representative remarked. Constraints on sugar production had arisen not from land ownership but from the shortage of land that was suitable for growing sugar, which required specific amounts of rainfall and types of soil.

The staff's output projections for 1989 had been limited to the sugar and tourism sectors, and on the basis of that growth, projections had been made for GDP growth, the staff representative explained. Projections for 1990 were more difficult; however, with respect to the balance of payments, the staff had taken into account a number of factors to project imports--notably the replenishment of stocks expected in that year, as well as the catch-up in the replacement of stocks and investments during the past two years.

To absorb excess liquidity, the authorities had been advised to consider the use of various kinds of securities--rather than only treasury bills--the staff representative said. The authorities had requested a Fund technical assistance mission to investigate that issue, among others, and the mission would discuss technical details with the authorities in February.

The phasing out of quantitative restrictions would be implemented over a two-year period beginning in July 1989, the staff representative stated.

On exchange rate policy, the staff representative pointed out that until 1987, the balance of payments had been approximately in equilibrium, if not surplus, in most years. Nevertheless, although the tourism sector had been competitive, growth in the rest of the economy, particularly in exports, had been hampered. The staff had endorsed the authorities' decision to devalue in 1987 mainly to restrain capital flight; that policy had also materially helped the export sector, which had been constrained by high domestic costs--the staff report included a chart for wage indices showing a very high wage level in most years during 1970-88 and a rapid rise in real wages compared with other countries. Thus, while the balance of payments had been in equilibrium, the economy could not diversify, but that situation had been improved by recent devaluations. As to the use of devaluations to stem the outflow of capital, in 1987 large outflows through both the capital and the current accounts had occurred in anticipation of a devaluation. In June 1987, the authorities had devalued by 17 percent but the outflow had continued; subsequently, the authorities had introduced restrictions, but they were not insuperable. Outflows had continued because of apprehension about a further devaluation, and in

October the authorities had adjusted the currency once more. In 1988, capital outflows had been greatly reduced as a result of both the restrictions and the elimination of the fear of devaluation.

The staff representative from the Exchange and Trade Relations Department observed that the real devaluation that had occurred, as illustrated in the staff report, provided a good backdrop against which the authorities could proceed to the next stages of liberalization, which included measures to dismantle import restrictions, rationalize the tariff structure, and reduce duties.

Mr. Shrestha remarked that the Fiji authorities had undertaken a number of measures--along the lines of those suggested by the Fund staff--as set forth in the budget speech of 1989, including the relaxation on restrictions on capital transfers abroad, and the restoration of wages and salaries of civil servants from January 1, 1989.

Moreover, the Government had announced a tax-free status for bonus shares to companies listed on the Stock Exchange, with a view to encouraging companies to obtain a listing, Mr. Shrestha continued. Similarly, in order to provide the Unit Trust of Fiji with sufficient investment opportunities, the Government intended to release some of the holdings of shares through the Stock Exchange.

Duty on certain imported consumer goods, such as apparel and items normally used by hotels, had been reduced; the export duty on log and sawn timber had been removed; and the allocation of capital expenditure in the 1989 budget had been made with a view to the diversification of the economy, Mr. Shrestha added. Those measures were consistent with the remarks made by many Directors, who had recognized the progress achieved thus far and who had identified areas where more needed to be done.

The Acting Chairman made the following summing up:

> Executive Directors commended the authorities for the prompt and effective measures--two devaluations, the tightening of fiscal and monetary policies, and wage restraint--that had been taken to protect the foreign position when a severe drought affected sugar production and political events led to large-scale emigration, capital flight, and a decline in tourism earnings. These measures had limited the fall in reserves in 1987 and had contributed to a sizable balance of payments surplus in 1988.
>
> Directors noted the marked improvement in Fiji's competitiveness in world markets, which had already led to rapid expansion of nontraditional exports. However, to achieve diversification and higher growth of output and employment, Directors considered it essential that industrial policies aim at export promotion rather than import substitution, and that an adequately restrained wage policy continue to permit Fiji to

compete in foreign markets. Directors, therefore, welcomed the recent policy announcements indicating export orientation, elimination of quantitative restrictions on imports, reductions in export duties, and the rationalization of the import duty structure. They also encouraged the authorities to reduce the regulatory burden on the economy and the scope of government intervention in price and wage determination. Regarding the Government's efforts to improve the efficiency and profitability of public enterprises, Directors suggested that the authorities should consider privatization.

Active structural reforms, however, would only bear fruit if buttressed by appropriately prudent fiscal and monetary policies. In particular, to help achieve a much needed increase in government savings, Directors suggested that recent efforts in restraining and streamlining current expenditures should be further consolidated and that consideration should be given to the introduction of a sales tax and other measures that would enhance revenue and improve the elasticity of the tax system. Given the continued political uncertainties, Directors cautioned the authorities and, in this regard, expressed some concern about the widening overall budget deficit in 1989 and noted the recent acceleration of inflation.

Directors noted the removal of controls on interest rates and encouraged the authorities to consider absorbing liquidity through the sale of government securities.

It is expected that the next Article IV consultation with Fiji will be held within 24 months, in accordance with the bicyclic procedure.

3. MALDIVES - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Maldives (SM/88/274, 12/20/88). They also had before them a background paper on recent economic developments in Maldives (SM/89/4, 1/10/89).

The staff representative from the Asian Department made the following statement:

> Two important policy developments took place after the staff concluded the 1988 Article IV consultation discussions with the Maldivian authorities in November 1988.
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> First, the government budget for 1989, which was presented in mid-December 1988, envisages an overall deficit of Rf 79 million--5 percent of GDP--as against the overall surplus of

Rf 54 million--4 percent of GDP--expected in the earlier official estimate used in the staff report. This turnaround mainly reflects a larger than expected increase in expenditure, which, following the November disturbances, aims at improving the internal security apparatus, sharply increasing the number of security personnel, and repairing damages caused by the disturbances. Expenditure on health is expected to increase with the establishment of atoll health centers. The budget also expects expenditure on education to increase with the construction of new schools. About 40 percent of the overall deficit will be financed by borrowing from the domestic banking system and the rest by borrowing from foreign sources.

Second, effective January 1, 1989, the authorities abolished the import quota system. Importers, however, are still required to obtain import licenses, but licensed importers are free to import any amount without restriction.

Experience in the past five years shows that actual budgetary performance has always been better than estimated at the time of the budget. Again this year, the authorities do not expect that all the expenditure estimates will actually be spent, given the manpower and other constraints to implementation. Hence, the eventual outturn for the fiscal deficit could be lower than budgeted. Nevertheless, the budgetary prospect underscores the importance the staff attaches to the need for the authorities to exercise selectivity in undertaking development projects and for the development of new sources of tax revenue over the medium term.

If in fact fiscal performance is reoriented along the lines indicated in the budget, there would be little scope for expanding bank credit to the private sector in 1989 while maintaining overall financial stability. The authorities have recently indicated to the staff that if the fiscal performance becomes expansionary in 1989, monetary policy will continue to be restrictive as in 1988 in order to neutralize any excessive monetary expansion.

Mr. Finaish made the following statement:

The continued strong GDP growth momentum in Maldives in 1988, combined with an expected budget surplus and an improving balance of payments position, is an indication of the efficiency of the authorities' economic management. The external imbalances of the early 1980s have been corrected, no doubt assisted by the adoption of prudent fiscal and monetary policies and the maintenance of a realistic exchange rate policy. At the same time, the economic plan for the 1988-90 period envisages a healthy balance between private sector investment in the tourism sector and public sector investment in the necessary health, education, and other infrastructure, effectively laying the foundation for continued economic progress.

When evaluating the economic performance of small island economies, one must take into account the special characteristics of these economies, especially when, like Maldives, they are geographically isolated from other nations and the land mass is spread over many small islands. Such economies are inherently fragile, as very minor exogenous shocks by international standards can have significant economic ramifications. The small size of such economies also effectively precludes the development of self-sufficiency in simple industries and forces these nations to concentrate on those few sectors where they possess a distinct comparative advantage: fisheries and tourism in the case of Maldives.

During 1988, tourism, fisheries, and distribution together accounted for 70 percent of overall economic growth. Tourist arrivals remained high as did resort occupancy levels. A large resort development program is expected to start in 1989, with 15 new islands being developed, of which 9 will be developed by the private sector. Growth in the fisheries industry was fueled by the full-year operation of a recently completed cannery and improved terms of trade. Construction of a second cannery is due to begin in 1989. Agricultural productivity continued to be disappointing, however, reflecting the limitations imposed by poor soil and restricted availability of cultivable land. The difficulties in the garment industry associated with the withdrawal of a foreign investor demonstrate the vulnerability of the Maldivian economy to minor exogenous developments.

The budgetary surplus achieved in 1988 was in marked contrast to the envisaged deficit of 9.2 percent and resulted from increased tourist arrivals, selected increases in import duties levied on luxury consumer durables, and a doubling of the tourist tax. Significant increased contributions were also made by the State Trading Organization and other public sector enterprises. Initial revenue and expenditure projections for 1989 had indicated that the fiscal surplus would increase from 1 percent to 4 percent of GDP, with continued dependence of revenues on developments within the tourist industry. However, after the recent disturbances, an increase in expenditure on internal security has been budgeted, which, if fully implemented, could result in a deficit of 5 percent of GDP. The actual deficit is expected, as in past years, to be smaller than the budgeted deficit. Grants and inflows of concessional foreign loans are expected to average 6 percent and 3 percent of GDP, respectively.

Despite the desirability of diversifying the Government's revenue base, the practical problems associated with administering a general sales tax in an economy where about 200,000 people are dispersed over 200 islands, and where there is very limited productive activity outside two traditional sectors, should not be underestimated. Any diversification of the revenue base can only be gradual and must be implemented cautiously.

Increased revenues have permitted a realignment of public sector wages at a more competitive level while allowing an overall fiscal surplus to be maintained in 1988. Wages increased by 30-40 percent for the lowest paid government workers and 50 percent for workers in the outer atolls and were a major cause of the 23 percent increase in current fiscal expenditure during 1988. While wage policy will inevitably continue to be influenced by the islands' tight labor situation, growth in public sector wages is expected to be significantly lower in 1989 and future years. More generally, despite the expected increase in revenues in 1989 and beyond, the authorities agree with the need for prudent expenditure policies.

Outstanding domestic credit fell by 24 percent in 1988, even though the broad money supply rose by 10 percent owing to an increase in net foreign assets. Credit to the public sector declined as a result of the budget surplus, while credit to the private sector was constrained owing to the high commercial bank reserve requirement. The authorities have adopted a cautious approach toward monetary expansion and are in the process of reviewing monetary policy in the light of budgetary and balance of payments prospects. They recognize that overall monetary expansion must be kept within acceptable limits, as only a combination of appropriate fiscal and monetary policies will help reduce inflation from its present level, thereby leading to an increase in real interest rates.

The authorities have been allowing market forces to determine the exchange rate since the devaluation of the rufiyaa in March 1987, and they are pursuing a policy of maintaining international competitiveness. Recently, the Government effectively abolished the import quota system, which is another favorable development. The rise in official reserves in 1988 to a level equivalent to two months of estimated 1989 imports, coupled with the decline in external debt and the debt service ratio to $73 million and 8 percent, respectively, reflects a satisfactory balance of payments position. The staff's medium-term projections for the balance of payments situation are also favorable. The authorities recognize the downside risks associated with these projections. They are alert to the sensitivity of the tourist industry to exogenous factors and are prepared to adapt their growth strategy in this or other sectors, if necessary, to changes in the external environment.

Mr. Comotto made the following statement:

Maldives is the Fund's smallest member. It has, however, been fairly successful in addressing the inherent problems of size, as well as the problems of remoteness and the geographical dispersion noted by Mr. Finaish, and the consequent vulnerability to exogenous developments. In particular, important progress has been made through the pursuit of cautious financial policies in adjusting the imbalances that emerged in the decade to 1983. Stabilization has allowed Maldives to sustain a vigorous development policy and to reap the full benefits of recent favorable external trends. Economic management has clearly been prudent in its inspiration, although its efficiency would seem to be open to continued improvement by rationalizing the focus of government intervention in the economy and by further reinforcement of technical areas like statistics, which have been a serious problem in the past.

There are also some unresolved difficulties and challenges for the long term that remain to be addressed. Most immediately, there is the problem of the rate of inflation, which remains high. The main source is wage pressure, reflecting the tightness of the labor market in the context of the rapid growth of the economy, but other factors have been the restrictive import regime and perhaps, within that context, the devaluation of March 1987.

I welcome the information that the import licensing regime has now been liberalized, although it will be necessary to ensure that the issuing of licenses is not implemented unduly restrictively. The authorities' intention to exercise greater wage restraint in the future after the recent adjustments is commendable. However, little success can be expected in reducing inflation further if tightness persists in the labor market. The authorities therefore need to examine the scope for enhancing labor mobility between industries. There would appear to be some potential for releasing labor from agriculture through improvements in productivity encouraged by, for example, reform of the land tenure system.

The present system of bonding, whereby new school graduates serve in the Government, should also be re-examined. Its elimination could provide at least a one-off increase in the labor force; there may also be general efficiency gains, given that the two years spent in bonded employment, by delaying new workers' entry into the labor force, would not seem calculated to help improve the overall level of skills. Moreover, there seems to be little advantage for the Administration in maintaining a cadre of temporary untrained young workers. At the very least, consideration should be given to allowing bonding in the private sector.

I also wonder to what extent the fisheries industry could yield spare labor, given that virtually all the recent improvement in productivity is estimated to have come only from the mechanization of existing craft. Additional productivity gains--and perhaps some reduction in manpower--might be available if incentives were improved by adjusting fish procurement prices. It should be possible to do this while preserving some margin against any large fall in world prices.

It is interesting to note that the labor force participation rate is 59 percent. If this rate is relatively low, perhaps the labor situation should be improved by maintaining some wage gradient across the archipelago with a view, notwithstanding the overcrowding on Male, to concentrating the work force somewhat more than at present.

More fundamentally, the tightness of the labor market also raises questions about the overall growth strategy being pursued in Maldives. The projected rates of growth may be too high, given the capacity constraints. Foreign labor may not be an acceptable supplement to the domestic work force beyond certain levels, and there are more immediate drawbacks to overreliance on foreign labor, as demonstrated by recent problems in the garment industry. Instead of such rapid overall growth, it might be preferable to concentrate on a policy of improving the value added that Maldives derives from its existing industries. For example, a return of less than $40 per tourist a day seems modest.

Another area of concern raised by the present staff report is the efficiency of resource allocation within the current framework of monetary and credit policy. It is not clear from the staff report why private sector credit demand has been so modest other than from the tourist and trading industries. Are lending opportunities limited by alternative public sector sources of lending? I note with some concern that the projected budget deficit in 1989 risks crowding out the private sector from the credit market.

There are clearly distortions in the financial system owing to the sectoral credit guidelines, and I endorse the staff's recommendation for their removal. I wonder whether the onerous reserve requirements have also produced distortions, for example, in the form of the disintermediation of savings and the substitution of foreign currency for rufiyaa. The authorities should examine the possibility of reducing the level of reserve requirements and allowing these requirements to be met in both domestic and foreign currency. There would also seem to be a general case for moving away from reserve requirements to a more active interest rate policy. This chair continues to believe that the achievement of real interest rates--which Mr. Finaish suggests is an objective of the authorities--cannot rely solely on a projected reduction of costs, as initial real rates of interest have a vital role to play in helping to reduce costs.

I echo staff concerns about the structure of the budget and in particular its overdependence on external taxes, which unhelpfully increases the vulnerability of an economy like that of Maldives. New sources of revenue are highly desirable, although it is difficult to know how far external taxes can be further increased without jeopardizing underlying activity. I also recognize the difficulty of imposing a sales tax in a country like Maldives, but I wonder to what extent it could be implemented with less of a problem at a wholesale level. On the expenditure side, there would appear to be a problem of priorities in the public investment program. Given the risks of activity failing to meet projected levels, it is important to be in a position to scale back investment quickly in an orderly manner.

It is also open to question as to whether the public sector is overextended in Maldives. The authorities have espoused a strategy of limiting public investment to the provision of infrastructure, but this may need more thorough implementation. The task of building an adequate infrastructure would seem to be demanding enough of the country's thin administrative resources to suggest that the divestiture of some economic activities currently conducted by public enterprises like the State Trading Organization and the Maldives Transport Company to the private sector would be beneficial.

Finally, I support the staff in urging that Maldives move to Article VIII status. Given the removal of its Article XIV restrictions and the fact that any new restrictions now require approval under Article VIII, Maldives is de facto an Article VIII country, and such a move could encourage other members to follow suit. I wonder, however, whether the hesitance of members to adopt Article VIII status reveals the need for a clearer and fuller explanation of the legal situation and policy implications, which could be provided to the authorities by staff missions.

Mr. Morita made the following statement:

Cautious macroeconomic policies and the proper use of foreign aid have brought satisfactory results to the Maldivian economy. Among other achievements, the fish cannery is now in operation, revenue from tourism soared in 1988, and, following the successful exchange rate depreciation in 1987, the current account balance was in surplus in 1987 and 1988.

The growth in tourism seems very satisfactory, which is an important development in the case of this economy, because the services receipts from travel nearly match total receipts from exports. That being said, we have some concerns about the heavy reliance of the economy on the travel sector. The ratio of the tourist tax to tax revenue is projected to be 36 percent in 1989. Almost one half of total bank loans have been directed to the tourism sector. I have already mentioned the importance of this sector to the external account and to the medium-term sustainability of the balance of payments. We agree that development of tourism presents the most promise of obtaining foreign exchange earnings in the future. But we should not forget that tourism is vulnerable to exogenous shocks beyond the authorities' control, such as the political situation in the region and economic conditions abroad. We support the authorities' plans to promote the growth of the tourism sector; nonetheless, too much reliance on tourism might be risky. In the context of the development plan, more emphasis could be placed on the fishery or garment sectors, and, on the fiscal front, the tax base could be broadened.

Exchange rate policy should be conducted flexibly. The trade account is showing a huge deficit, and a flexible exchange rate policy would be helpful in improving competitiveness. Also, tourism is sensitive to exchange rate developments.

The high wage increase in the public sector in 1988 was understandable in light of the tight labor market. But with the current pace of economic growth, the labor market seems to be getting tighter, and the inflationary impact of wages is apparently increasing. Moreover, the exchange rate, under the flexible policy, might also have an inflationary impact in the future, when it might be difficult to control wage developments under the current scheme, thus hindering the restoration of international competitiveness. Some consideration should be given to this point.

The cautious stance on monetary policy should be continued. The staff suggests that the reserve requirement seems high and that there could be scope for an active interest rate policy. We agree that the enhancement of the efficiency of the monetary system is appropriate and could reduce the spread between the lending and deposit rates. Nonetheless, we hope that measures in this direction will be taken cautiously, with close monitoring of monetary developments, because subduing inflationary pressure should be the top priority in this rapidly growing economy. Also, given the strong demand for foreign currency, a tight monetary policy would be a good alternative.

Mr. Vasudevan made the following statement:

We are in general agreement with the staff appraisal. The economic performance of Maldives in recent years has been commendable. The authorities should be congratulated for their economic management, particularly because Maldives--the member with the smallest Fund quota, SDR 2 million--has maintained a high annual growth rate of 13 percent, and has allowed a consumer price increase of only about 7 percent in the past five years. Moreover, the authorities have turned the fiscal situation from deficits until 1986 to surpluses in 1987 and 1988. The strong growth in revenues, with restraint in expenditures, had been the main feature of the past two years. The revenue/GDP ratio has been high, averaging close to 29 percent in the past five years, and the tax revenue/GDP ratio was about 17-18 percent in the past two years--high compared with the outcomes in most developing countries.

According to the 1989 budget, there will be a deficit in 1989, compared with the surplus of about 1 percent of GDP in 1988, because of a large rise in estimated expenditures consequent upon the November disturbances. Mr. Finaish stated that, according to past trends, the fiscal deficit may ultimately be lower than estimated. It appears that, notwithstanding the rise in estimated expenditures, there will be no adverse effect on the buoyancy of revenues from import duties and the tourist tax. The staff comments that the tax base needs to be broadened, as the tax burden on the tourism sector may soon reach its limits. In this connection, the staff alludes to the recommendation of previous staff missions to introduce a sales tax. The implementation of this tax requires some administrative capacity--a point mentioned by Mr. Finaish--and we wonder therefore whether the staff could give instances of any other taxes that could be put into effect without incurring administrative difficulties.

The authorities should be warmly commended for their management of public sector enterprises, which contribute an average of about 20 percent of domestic revenue to the government budget. All efforts should be made to maintain this feature, which is rarely seen in many countries. In addition, despite recent wage increases and pressures, growth in current expenditures has been kept under restraint in the past two years, as shown by the fact that the current expenditure/GDP ratio, which was 20.3 percent in 1986, fell to 19.2 percent in 1987 and further to 17.4 percent in 1988. It appears that current expenditures will rise in 1989. It will be necessary from a longer-term point of view to monitor current expenditures and to take any necessary measures to restrain them, especially as there could be pressures to increase capital expenditures for diversification of the economy and of the export base in the years ahead. In this context, we see considerable merit in the staff's suggestion that development projects be undertaken only after carefully assessing national priorities and implementation capacity.

On monetary policy, it appears that there is not much scope for expanding bank credit to the private sector in 1989. This is not to say that a gradual relaxation of credit controls in the present circumstances could not be considered, with careful monitoring of monetary developments and if the actual fiscal expansion is less than estimated. The staff does not want brakes on lending for trade and tourism applied by having guidelines on credit to priority sectors. The staff also believes that easing of credit controls should not lead to a diminution of foreign financing in the proposed development of tourist facilities. The question is how financing can be ensured unless there are domestic credit allocations for tourism. Clarification of this point would be useful.

With respect to external policies, the export performance of Maldives in the past two years has been commendable, facilitated by the recovery in fish prices and in tourism, and partly by a realistic exchange rate policy. The authorities recognize that the export base is narrow and that export diversification is necessary, but it will take time. The authorities favor gradual liberalization of import controls, and, in fact, they abolished the import quota system effective January 1. This appears to be in tune with recent trends in the buildup of official reserves. We also commend the authorities for eschewing foreign commercial borrowing.

As regards the medium-term growth strategy, we are in general agreement with the staff. The alternative scenario, with the assumption of lower growth in tourist arrivals, is helpful; it shows the need to diversify exports and to select development projects carefully on the basis of strict national priorities.

We support the continued application of the bicyclic consultation procedure.

Mr. Posthumus remarked that he was uncertain how diversification could be achieved in a small island economy. In an earlier Board discussion of a similar case, the staff had suggested that when the country's economic situation was favorable, the authorities should decrease foreign debt to the extent possible, or, if no foreign debt existed, they should invest abroad. For political reasons, that suggestion was not easy to implement because when a country's economic situation was good, the propensity was to consume rather than to save. He asked the staff to comment. He would also appreciate explanation of why, over the past few years, there had been a high growth rate in Maldives while private consumption had declined.

The Acting Chairman observed that he had also wondered in discussing similar economies whether reserve and debt management could not provide some cushion to a vulnerable economy that had little scope for diversification.

The staff representative from the Asian Department remarked that in Maldives only four nonfinancial public enterprises performed commercial functions: the State Trading Organization; the Maldives National Shipping Management, Ltd.; the Maldives Transport and Contracting Company, in which some 40 percent of shares was owned by the private sector; and Air Maldives. Given the rudimentary capital market in Maldives, large-scale privatization was not possible. In general, the authorities were willing to consider proposals for joint ventures and foreign participation. The development strategy aimed to enhance the role of the private sector in future, thereby increasing its relative share, and in that manner Maldives would be able subsequently to reduce the relative size of the public sector.

It had been observed that perhaps the authorities' growth strategy was not achievable, given the labor market and other constraints, the staff representative continued. The staff believed that the authorities should be ready to moderate that strategy if the need should arise; however, the growth rate was high because of the particular pattern of development envisaged in the strategy. About 75 percent of the required investment in resort development was provided by foreign sources--largely tour operators--who would undoubtedly ensure that the resorts were fully booked. Thus, the high investment and, later on, the flow of income from that investment should enable the country to achieve the targeted growth rates. Moreover, large public investment in infrastructure would be required.

Maldives was considering increasing value added, the staff representative noted. For example, there was a shift toward higher value added for canned fish exports; more of the produce and fish required by resorts was being provided locally; and poultry production was expected to rise to fill tourist demand from the resorts. Also, a hotel school had been founded to train prospective employees for resort development projects. The planned shift of resorts to outer islands should promote the employment of women in the tourism sector, where, at present, female participation was very low, especially compared with their participation in other countries. Because of the small number of women employed, the country's labor participation rate was only 59 percent.

Previous staff missions to Maldives had recommended the introduction of a sales tax, the staff representative recalled. Because of the administrative difficulties of such a tax, especially in the widespread islands forming Maldives, it had not been introduced. Nevertheless, the staff continued to believe that it should be possible to have a single-point sales tax at the wholesale level on imports of consumer goods and on domestic manufactures, such as textiles, canned fish, and milk.

The issue had been raised of how the authorities could ensure that foreign financing of the proposed development of tourist facilities was not reduced, given the desire to relax credit controls, the staff representative noted. Local currency needed for expansion of the tourism sector would be about Rf 50 million, against total credit outstanding to the private sector of Rf 160 million at the end of 1988, which involved a 12-15 percent increase in each of the years 1989 and 1990. In addition, demand for credit for trade would rise. Those numbers were high in relation to past experience, and the authorities had no intention of relaxing credit to that extent. For that reason, the staff considered it possible to ensure that foreign investment in the tourism sector would take place. Moreover, the financing plan for each resort development project would be carefully scrutinized by the authorities, particularly to ensure that foreign financing would be adequate.

The staff had recommended, and the authorities were considering, an active interest rate policy, the staff representative said. At the moment, domestic lending rates were subject to the ceiling of 5 percentage points over the New York prime rate, resulting in relatively expensive financing for the tourism sector.

In the medium term or somewhat longer term, diversification of economic activity should be possible, the staff representative from the Asian Department remarked. At present, the country depended largely on imports for consumer goods; therefore, there was scope for efficient import substitution, for example, vegetables, fruit, and poultry that were air freighted at present from Singapore or Sri Lanka at high cost. However, Maldives did not have a tradition of farming, and the main occupation was fishing. The Government had tried to induce people to agriculture through special credit schemes for supplies and extension services, but the Maldivians were choosing other sectors where remuneration was higher. Thus, while participation in agriculture could perhaps be encouraged in the long run, the immediate prospects were not favorable. For that reason, the authorities had, in the investment program for the next few years, focused on tourism, where foreign exchange could be earned promptly, and had planned for diversification of the economy in the long term.

Mr. Finaish said that the authorities did not expect the large deficit forecast for the budget to materialize, based on past experience. The increase in expenditures was mainly attributable to the disturbances in November 1988 and the subsequent costs of security and repairs; a significant amount of expenditures would also be devoted to education and health. The authorities were currently reviewing monetary policy in general, including the reserve requirement.

The possibilities for economic diversification were limited in Maldives as in other small island economies, Mr. Finaish remarked. Agriculture had been mentioned, but the soil was poor and the land available for cultivation was limited. Nevertheless, the cultivation of fruit and vegetables was a promising area, although the use of fertilizers in the agricultural sector had provoked concern about the environmental effect, for example, on fishing--an important sector in Maldives. A number of people involved in agriculture had moved to other sectors, particularly the garment industry, which had grown quickly over the past 15 years because of the inflow of capital.

The Board's discussions that day had focused on three similar economies, Mr. Finaish noted. Such small island economies were vulnerable to domestic and exogenous developments and deserved international support in their attempts to overcome their vulnerability. It was worth emphasizing that in a small economy like that of Maldives, it could be misleading to focus on year-to-year changes that could be distorted by large-scale developments of a one-off character, such as the timing of a major investment, as noted by Mr. McCormack in an earlier discussion. Capital movements or natural disasters--although small by international standards--could affect those countries dramatically. Similarly, implementation of a few well-conceived development projects could have a significant beneficial impact.

The Acting Chairman made the following summing up:

> Executive Directors supported the thrust of the staff appraisal, the cautionary tone of which was perhaps made even more appropriate by the authorities' most recent budget decisions. They commended the authorities for having pursued prudent financial policies thus far--including sound management of the state enterprises--which had materially contributed to the satisfactory economic performance. Directors noted the authorities' ambitious growth strategy for the medium term, based largely on the development of additional tourist resorts. In view of the increasing tightness in the labor market and the continued pressures on prices, they stressed the importance of the authorities standing ready to adopt a more moderate growth strategy, should such a need arise. Efforts also should be geared to greater diversification of production, perhaps if economically feasible in fisheries, in some agricultural activities, and in manufacturing to lessen the country's vulnerability to factors affecting tourism income. There also might be greater room for private initiative and perhaps for divesting public enterprises.
>
> Directors noted the relaxation of the budgetary stance that appeared to be in store for 1989, and remarked that it might impede continuation of satisfactory economic growth and further improvement in the balance of payments and in the external debt

position that had been achieved in 1988. They urged the authorities to exercise restraint in expenditure, in particular by limiting the growth of the wage bill and by undertaking projects only after a careful review of priorities and of implementation capacity. Given the narrow revenue base, Directors considered that such expenditure restraint would be essential for limiting government borrowing from the banking system to a level that would avoid crowding out private sector activity. For the medium term, Directors emphasized that attempts should be made to diversify the sources of tax revenue, taking into account the special nature and problems of tax collection in an archipelago.

Directors commented that the restrained credit policies pursued by the authorities in recent years had contributed importantly to the improvement in the external payments position. Given the expansionary impact of budgetary operations envisaged for 1989, there was some concern that the burden on credit policy might become excessive. To increase the effectiveness of monetary control, the authorities were encouraged to streamline monetary policy instruments and to seek ways other than credit guidelines to facilitate the flow of financial resources to priority sectors, while preserving overall financial stability. They also encouraged the authorities to make more active use of interest rate policy.

Directors welcomed the continued improvement in the balance of payments in 1988, and they considered the authorities' recent action to abolish the import quota system appropriate. They endorsed export diversification as a medium-term objective and commended the prudent external borrowing policy that was being pursued. They welcomed the market-oriented exchange rate policy, urging the authorities to monitor closely movements in the real effective exchange rate with a view to avoiding any erosion in competitiveness. The authorities were encouraged to consider the acceptance of the obligations of Article VIII, Sections 2, 3, and 4.

It is expected that the next Article IV consultation with Maldives will be held within 24 months, in accordance with the bicyclic procedure.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/6 (1/18/89) and EBM/89/7 (1/27/89).

4. HAITI - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE K-1

1. The complaint of the Managing Director under Rule K-1 dated January 12, 1989 on Haiti in EBS/89/4 (1/13/89) is noted. It shall be placed on the agenda of the Executive Board for February 13, 1989.

2. The Fund urges Haiti to become current in its financial obligations to the Fund promptly and to avoid thereby the need for the Fund to take remedial action.

3. Consideration of the complaint in accordance with Rule K-1 particularly affects Haiti. The member shall be informed by rapid means of communication of this matter and of its right to present its views through an appropriately authorized representative.

Decision No. 9066-(89/7), adopted
January 23, 1989

5. MULTILATERAL INVESTMENT GUARANTEE AGENCY - DESIGNATION OF EXPERT BY MANAGING DIRECTOR

The Executive Board approves the letter, set out in the Attachment to SM/89/12, from the Managing Director to the Acting Executive Vice President of the Multilateral Investment Guarantee Agency, stating that the Managing Director has been authorized to appoint an expert to determine the reference rate of exchange in the circumstances described in Article 16 of the draft General Conditions of Guarantee for Equity Investments set out in Annex II of SM/89/12.

Decision No. 9067-(89/7), adopted
January 24, 1989

6. GUYANA - TECHNICAL ASSISTANCE

In response to a request from the authorities of Guyana for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/89/11 (1/13/89).

Adopted January 19, 1989

7. MALAWI - TECHNICAL ASSISTANCE

In response to a request from the Malawian authorities for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/89/14 (1/19/89).

Adopted January 25, 1989

8. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 88/90 through 88/93 are approved. (EBD/89/7, 1/11/89)

Adopted January 18, 1989

b. The minutes of Executive Board Meetings 88/94 through 88/98 are approved. (EBD/89/12, 1/18/89)

Adopted January 25, 1989

9. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/89/8, Supplement 1 (1/23/89), EBAP/89/17 (1/17/89), EBAP/89/18 (1/19/89), and EBAP/89/21 (1/25/89) and by Advisors to Executive Directors as set forth in EBAP/88/18 (1/19/89) and EBAP/89/20 (1/24/89) is approved.

APPROVED: July 19, 1989

LEO VAN HOUTVEN
Secretary