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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 95/108

10:00 a.m., November 15, 1995

Contents

Executive Board Attendance

P. R. Narvekar, Acting Chairman

Executive Directors	Alternate Executive Directors
	M. F. Melhem, Temporary
	L. Fontaine, Temporary
	D. Giga, Temporary
	M. B. Alemán, Temporary
	S. O'Connor, Temporary
	N. L. Laframboise, Temporary
	J. Mafararikwa, Temporary
	R. Glennerster, Temporary
	N. Prasad, Temporary
	R. Bessone Basto, Temporary
J. E. Ismael	
	O. Issaev, Temporary
	J. John, Temporary
	A. Cserés, Temporary
	T.-M. Kudiwu, Temporary
	J. M. Abbott, Temporary
	M. W. Ryan, Temporary
	T. Oya, Temporary
	M. H. Mahdavian, Temporary
	J. A. Costa, Temporary
	R. J. Heinbeucher, Temporary
	T. K. Gaspard, Temporary
	V. Y. Verjbitski, Temporary
E. L. Waterman	J.-H. Kang
	H. Petana, Temporary
	P. I. Botoucharov, Temporary
	G. A. Kyriacou, Temporary
	Zheng H., Temporary

W. S. Tseng, Acting Secretary
D. M. Rajnes, Assistant

<u>Also Present</u>

IBRD: H. M. Codippily, East Asia and Pacific Regional Office. Policy Development and Review Department: J. Pujol. Research Department: H. Faruqee. Secretary's Department: M. J. Miller. Southeast Asia and Pacific Department: K. Saito, Director; C. M. Browne, M. Cangiano, M.-H. Duprat, N. M. Hairfield, H. E. Khor, I. Kim, K. M. Meesook, E. Sidgwick. Treasurer's Department: D. P. Kelly. Office of the Managing Director: J. G. Blanch, A. A. Zimmerman. Advisors to Executive Directors: H. Mori, G. Mucibabici. Assistants to Executive Directors: A. L. Coronel, C. M. Gonzalez, A. M. Koulizade, E. Kouprianova, J. A. K. Munthali, Ng C. S., S. Rouai, K. Sakr, S. Simonsen.

1. WESTERN SAMOA - 1995 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1995 Article IV consultation with Western Samoa (SM/95/280, 10/19/95). They also had before them a statistical annex (SM/95/286, 11/2/95).

The staff representative from the Southeast Asia and Pacific Department made the following statement on Fiji, Kiribati, and Western Samoa:

> This statement presents additional information on Fiji's budget for 1996, which was tabled in Parliament on November 10. It also compares selected structural features of Fiji, Kiribati, and Western Samoa, and policies to promote economic growth--the key policy challenge in all three countries.
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> On November 10, the Minister of Finance and Economic Development presented to Parliament the Government's 1996 budget proposals, which envisage a further widening of the overall budget deficit to about 3 percent of GDP. Total revenue and grants are projected to increase slightly while total expenditure would increase by about 1 1/4 percent of GDP, mainly on account of a higher allocation for capital spending and an initial allocation of F$20 million (3/4 of 1 percent of GDP) to recapitalize the National Bank of Fiji.
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> The revenue measures proposed in the budget, which consist mainly of adjustments in import duties on various items, are broadly revenue neutral. However, the budget also proposes an enhancement of certain fiscal incentives to promote export-oriented industries and tourism. On the expenditure side, current expenditures are projected to remain unchanged as a share of GDP in 1996. However, the budget contains some measures that could have a longer-term impact including a freeze on the size of the civil service; the adoption of accrual accounting system to improve financial management; and the introduction of a merit system for pay increases.
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> While the staff has not had an opportunity to discuss the budget with the authorities, the staff's preliminary view is that the 1996 budget appears to represent a further departure from the medium-term objective of fiscal consolidation and could rekindle inflationary pressures or weaken the external position. The staff would therefore encourage the authorities to monitor closely price and balance of payments developments with a view to taking pre-emptive measures to preserve the macroeconomic gains of the past two years.
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> The three economies vary considerably in terms of size, institutional structure, and level of development, with Fiji at one end of the spectrum and Kiribati at the other (see Annex).

Nonetheless, they share many common features and policy issues, and, taken together, they provide a regional perspective on the development problems facing the small Pacific island countries.

The single most important problem faced by the three countries is the chronically weak--or even negative--output growth that is also highly vulnerable to external disturbances. By contrast, financial stability has been broadly maintained, and although there were recent periods when lax financial policies contributed to inflationary pressures or external imbalances, such lapses in policy stance appear to have been brought under control.

The public sector in the three countries is extensive and is a major source of formal sector employment and income--a counterpart of which is a generally undeveloped private sector. Government expenditures in Kiribati and Western Samoa are particularly large, reflecting massive infrastructure needs. Fiji relies mostly on tax and other domestic revenues to finance expenditures, while Kiribati and Western Samoa also utilize substantial amounts of foreign grants. Bank borrowing in all three countries has been relatively small.

Fiji and Western Samoa established their central banks in 1984, and their currencies are pegged to baskets of their major trading partners' currencies. The financial sector in Fiji is fairly developed, and monetary policy is conducted through open market operations in a growing interbank market. Western Samoa's financial sector is less mature, and indirect instruments of monetary control are in the process of being introduced. Kiribati uses the Australian dollar as its national currency, and the Government has limited influence over monetary developments.

Trade regimes in all three countries are relatively open. Exports are concentrated in a few commodities in all these countries, but the structure of their balance of payments differs. Fiji's import dependence is relatively low; merchandise exports and tourism account for the bulk of its foreign exchange receipts, and inward transfers are small. By comparison, Kiribati and Western Samoa rely heavily on private remittances--as well as official grants--and Kiribati receives substantial income from its foreign financial assets. Growing tourism and export processing activities in Western Samoa have significantly strengthened the country's ability to earn foreign exchange.

In recent Article IV consultations with the three countries, Executive Directors underscored the importance of maintaining macroeconomic stability while strengthening medium-term growth prospects--through a broad range of structural reforms. In particular, emphasis was placed on promoting private sector activity through the consolidation of the public sector, upgrading of infrastructure, and removal of institutional constraints.

Continued disappointing performance with respect to output growth and diversification reflects in large measure slow progress in implementing structural policies. In each country, little has been achieved in restructuring the civil service or reforming the land tenure system. Public enterprise reform, including privatization, has been initiated but progress has been sluggish. Efforts have been made to streamline investment procedures but, despite selective fiscal incentives, inflows of foreign investment have not been sustained. The area in which there have been significant improvements in all three countries is the tax system; also, policies to liberalize the financial system have been undertaken in Fiji and Western Samoa.

Following the adoption of a structural adjustment program in the late 1980s, Fiji had made significant strides in lowering import tariffs and removing quantitative controls, moving toward broad-based indirect taxes, and liberalizing the financial sector and improving monetary management. However, little has been accomplished in the last few years, and, in particular, public enterprise reform has yet to gain ground. Fiji's economic prospects are also clouded by political uncertainties, which have resulted in a persistent lack of confidence, continued outflows of skilled labor, and a decline of private savings and investment.

With less-developed institutions, Kiribati's capacity to implement structural policies is modest compared with the other two countries. During the short time span since the country joined the Fund, policy has focused on strengthening the legal and institutional framework. Thus, progress in implementing reform measures has been limited to taking initial steps toward a more efficient tax system, and adopting a framework for public enterprise reform. The attainment of higher output growth has also been hampered by inadequate infrastructure, development of which is restrained by the capacity to implement the public investment program effectively.

Implementation of reform policies has been uneven in Western Samoa, but gains have been made in restructuring public enterprises--including most recently the financially stricken national airline, introducing the value-added and general sales tax, and preparing groundwork for indirect monetary control. Negative growth rates during 1990-94 highlight the economy's vulnerability to natural adversities, but prospects for stronger performance could improve in light of recently renewed momentum in the privatization program and foreign investment in a few large projects.

While preserving financial stability remains central to Fund staff advice to the three Pacific island countries, emphasis has increasingly been given to efforts to address structural barriers to more rapid growth and diversification. Toward this goal, technical assistance to the region has been intensified, with a focus on institutional building and fiscal and monetary management. In this regard, the establishment of the Pacific Financial Technical Assistance Center has greatly facilitated effective and timely provision of advice for the past two years. The objective of expanding growth potential is shared by the World Bank, the Asian Development Bank, and key bilateral donors, which have also provided substantial financial and technical support to upgrade infrastructure and institutions, strengthen manpower, and develop key sectors.

Mr. Waterman made the following statement:

Real growth in the Western Samoa economy is expected to rebound to 6-7 percent in 1995, supported by the recovery of agro-business and strengthening tourism. In the first nine months, the value of exports rose sharply as crops recovered from the devastating impact of two cyclones and a taro leaf blight in the period 1990-1993. Similarly, tourism receipts and private remittances for the first eight months of this year increased by 28 and 14 percent, respectively, over 1994. Inflation has come down from 18.4 percent at end-December to 3.7 percent at end-September through tight monetary policy, and is projected to decline further to just over 2.0 percent at year-end. At the end of September, gross reserves increased to WS$115 million, equivalent to over six-months import cover, and the balance of payments is now projected to be in surplus this year following three consecutive years in deficit.

Notwithstanding these positive developments, my authorities are in broad agreement with the staff on both the short and medium term measures that are needed to ensure macroeconomic stabilization, and help put the economy on to a sustainable growth path over the medium term. The staff report has covered these areas comprehensively. I agree with the staff that the key issue facing my authorities in the short term is the 1995/96 budget. Although the considerable fiscal and balance of payments impact of Polynesian Airlines has been arrested by tight financial policies and successful restructuring, outstanding commitments remain which have to be met in future outlays. The stance of fiscal policy in 1995/96 will remain tight. Salaries and wages will be restrained, and my authorities intend to hold expenditures within appropriations. The introduction of performance budgeting and tight monitoring procedures in the Treasury will enhance transparency and accountability. Efforts are also in train to improve administrative capability in tax collection. These

> measures should see the overall budget deficit come down further from 4 percent of GDP, as recommended by the staff.
>
> On monetary policy, the auctioning of treasury bills is now likely to commence in February, with the support of Fund technical assistance. Parliament will also be considering in its next session amendments to the Financial Institutions Bill which will strengthen the Bank's supervisory role. These measures will progress further the liberalization of the financial system. The stance of monetary policy will remain directed at containing inflation.
>
> My authorities recognize the critical need to address those structural impediments constraining full development of the economy's potential. They are currently working on economic reform strategies that will encompass these structural issues for implementation in 1996.
>
> Finally, my authorities express their appreciation to management and the staff for their continuing support; continued Fund advice on the ongoing challenges faced by Western Samoa is welcomed.

Extending his remarks, Mr. Waterman noted that not all island economies were comparable, but many had enough in common to make it useful for Directors to discuss them in a single Board meeting. He supported the staff's useful initiative to consider the countries together.

Mr. Oya made the following statement:

> At the outset, I would like to commend the authorities for having taken appropriate policy actions after the natural disasters and the financial crisis of Polynesian Airlines. I am pleased to see their efforts beginning to bear fruit. I also commend the staff for having provided very helpful advice to the authorities.
>
> As I support the thrust of the staff appraisal, I would like to make only two comments for emphasis.
>
> First, I join the staff in recommending taking a more ambitious fiscal stance. While it is understandable that the current expenditure compression is unsustainable, I believe that a more prudent fiscal policy should be taken in order to solidify the stabilization gains already made.
>
> To this end, the authorities should take actions promptly aimed at enhancing revenues and trimming the size of the Government. In this connection, it is also crucial to restructure the still large public enterprise sector. The authorities should

take resolute measures to improve the financial performance of the public enterprises, so as to avoid the need for continued Government subsidies.

Second, the authorities should pay more attention to the creation of a dynamic private sector, in order to ensure sustained growth over the medium term. In this connection, the most urgent task for the authorities is to introduce more flexibility into the current land system, which continues to hamper productive land use. I am concerned that this system has a very discouraging effect of foreign investors' decision making.

That said, the authorities' basic economic policy stance is very encouraging. I hope they will continue to take appropriate measures in cooperation with the Fund to further improve the economic situation.

Finally, I would like to commend the staff's written statement, which bunched the three island countries discussed today. This kind of statement is very helpful because it clearly shows each country's economic characteristics by comparing these countries in detail.

With these remarks, I wish the authorities well and every success in the future.

Mr. O'Connor made the following statement:

I would like to join the staff in supporting the plan of the authorities to sustain positive economic growth and low inflation while embarking on structural reforms that will improve growth potential. Battered by supply shocks over recent years in the agriculture and transportation industries, the economy has had difficulty in recovering its previous potential. While this may be due partly to macroeconomic policy restraint designed to cap incipient inflationary pressures, it also reflects persistent structural rigidities in the economy. Price controls, interest rate controls, direct credit allocation and land use controls continue to delay the development of the productive private sector required for stronger, sustainable economic growth.

Since I am largely in agreement with the staff's appraisal and have little to add with regard to the current stance of macroeconomic policies, my comments will focus on a couple of medium-term issues.

As the staff report notes, the fiscal authorities were able to absorb the payment obligations of the Polynesian Airlines last year only through arbitrary and unsustainable reductions in planned current and capital spending. Since a large part of these payments cleared overdue obligations, the authorities are in a position this year to renew program spending on education and infrastructure projects. Even though priority is being given to projects with grant financing this year and next, and spending on public wages and salaries is currently under firm control, the authorities must remain cautious in their spending. With an external debt/GDP ratio of 134 percent and debt-servicing costs absorbing a third of trade revenues, there is little room for policy slippage.

As suggested in the staff appraisal, the risk for fiscal policy slippage is substantial over the medium-term because of the absence of a well-designed program of expenditure cuts, and especially with regard to the necessary step of downsizing the civil service. Indeed, the staff's medium-term baseline scenario, which could be described as a best intentions scenario, indicates that, while a fiscal surplus could be achieved by the end of 1996, it would still take another 4 years to lower the debt/GDP ratio to its 1990 level of 82 percent. Furthermore, excluding the airline debt assumed by the Government, over 88 percent of the remaining debt is from multilateral financial institutions. Since 1990, the private sector's share of the debt has declined from about 7 percent to about 2 percent with bilateral debt (primarily from China) filling the gap. Private investors may already be signaling concern by backing away and, as a result, the discipline on fiscal spending imposed by private debt markets is diminishing.

The authorities have, to their merit, taken steps recently to tighten monetary and private credit conditions. While such actions are consistent with anti-inflation objectives in response to adverse supply shocks and slower private sector investment, it is difficult to assess how big an impact this has actually had on inflation in the presence of price controls. Moreover, price controls are likely contributing to the weak recovery in economic potential by distorting price signals and discouraging the productive private investment required to achieve the authorities' goal of economic diversification. These distortions can become even more severe over the short-term as the extraordinarily large planned increase in the minimum wage interacts with price controls. I urge the authorities to consider eliminating these controls at a preliminary stage in their planned restructuring process and join the staff in recommending a minimum wage increase more closely related to productivity improvements.

The authorities have also announced a plan to introduce auctions of central bank securities early next year as a vehicle for direct monetary control. While I consider this to be a positive step, the authorities--contrary to the good advice of the staff--decided to postpone liberalization of banking markets so that all financial market reforms could be undertaken simultaneously. There is ample evidence to suggest that the judicious sequencing of financial reforms, beginning as soon as possible, yields the most promising results. While strong prudential regulations and financial sector supervision are among the first requirements for financial reform, it is also clear that liberalized bank interest rates and market-based short-term loan and deposit markets are critical for the success of primary auction markets and secondary securities markets. Delaying the introduction of banking sector liberalization simply complicates the introduction of auction markets for monetary policy purposes.

I was also disappointed to read that the amendments to the Financial Institutions Bill proposed last year, and aimed at strengthening the supervisory capacity of the central bank, have still to be enacted. While I understand that some recent technical problems have slowed enactment earlier this year, I am concerned that the upcoming elections may delay enactment further. Early financial sector reform is a key ingredient to successful privatization of public enterprises and to the development of a dynamic, well-diversified industrial base. The authorities should recognize that the continuous delays in financial sector reform suggest to investors that the Government is not serious in its commitment to private-led development. These delays imply that the authorities are content to allocate credit directly to Government and its enterprises by rationing credit for productive private investments. I recommend that the authorities underline their commitment to private sector growth by embarking on financial reforms without further delay. They might begin with the quick passage of the Financial Institutions Bill and by accelerating, as much as possible, the active participation of the newly privatized Post Office Savings Bank in liberalized banking markets.

Finally, I wish the authorities good fortune in their challenging task ahead.

Ms. Zheng made the following statement:

The upswing of Western Samoa's economy, following the natural disaster and the financial crisis of Polynesian Airline, is commendable. Several indicators show positive developments: real GDP growth picked up strongly from minus 7.8 percent in 1994 to 6.7 percent in 1995, inflation declined sharply to a single digit level in 1995, and balance of payments exhibited a significant surplus of 8.2 percent of GDP, which, in turn, brought foreign exchange reserves to the equivalent of 5.7 months' worth of imports. Notwithstanding these positive aspects, caution should be emphasized on the fiscal front, namely with regards to the impact from restructuring Polynesian Airline. On the whole, we broadly share the staff's view, especially on the point that priority in the policy mix should lie in the improvement of fiscal performance.

On the fiscal front, we agree that the underlying fiscal performance is healthy. While welcoming the authorities' decision to restructure the Polynesian Airline, we see that the task is extremely challenging, as expressed by the 9.1 percent or maybe 10.3 percent of GDP fiscal deficit in 1995. Such a large deficit will inevitably involve the need for financing, which is mainly reflected in the sharp increase in domestic financing. Therefore, we echo the staff's view that more work should be done to further improve the underlying fiscal performance in order to allow enough room for the Polynesian Airline restructuring. An increase in tax revenue, improvement in tax administration and reduction in supplementary expenditures would be helpful, and we would like to know to what extent these measures are possible and how they will improve the budget.

Related to this issue, public enterprise reform also has important significance. Improving the public utilities performance to avoid more Government subsidies is required. In this connection, the authorities' phased privatization plan for public enterprises is welcome.

On monetary policies, we agree with the staff that the domestic demand needs to be carefully managed. Given the large fiscal deficit burden and the uncertainties as to whether it will be relieved in the near future, it is advisable to keep the monetary stance restricted. The authorities should be cautioned against actions to relax domestic credit. In this regard, the authorities intention to shift from direct instruments to indirect instruments is welcome. However, the authorities should be encouraged to keep the transition balanced. To bring about a sound supervisory and regulatory framework, a temporary reliance on credit control for at least one year of the most serious fiscal difficulty is not a bad idea. Furthermore, an assurance of nonbank financing for the budget deficit should be guaranteed.

Finally, a few words on structural reform. For a small open economy, it is understandable that the problem of extremely low savings and investment can not be solved overnight. Long-term and serious structural reforms should be firmly pursued in order to upgrade the economic structure, establish a sound financial system and reform the inefficient public enterprise system. In this regard, we are pleased to see that the three-phase structural reform program has been worked out, and we are looking forward to seeing the results.

With these remarks, I wish the authorities every success.

Mr. Ismael said that he had been impressed by Western Samoa's economic performance. His own country, Indonesia, had faced an overheated economy in the preceding two years, and could surely learn from the authorities how to reduce inflation from 18-19 percent to 2 percent, as was expected at end-1995.

He wondered, nonetheless, how the budget deficit of 4 percent of GDP had been financed, given that there had been neither a current account deficit nor inflationary pressures, Mr. Ismael stated.

Mr. Ryan made the following statement:

The staff paper identifies some key policy objectives for the Western Samoa authorities. These include: increasing domestic savings, improving the climate for private investment, and establishing a stronger, less vulnerable external position.

One is struck by a few factors in particular which underline weaknesses and vulnerabilities in the medium-term outlook: (1) a large public sector, in which 50 percent of current expenditures are devoted to the wage bill, (2) the very weak external trade account and substantial external debt (albeit largely concessional), and (3) still sluggish private sector activity. Reversing these shortcomings requires the following:

Redoubling efforts to downsize the public sector and its role in the economy. Spending needs on infrastructure and social services need to be accommodated within a leaner budget. The staff's more ambitious targets for deficit reduction seem sensible given stabilization objectives and the need to preserve fiscal maneuvering room.

Reorienting external account performance toward exports of goods and services as opposed to Western Samoan workers (and their remittances). This means giving priority attention to accelerating privatization as well as increasing flexibility in the land tenure system. Large increases in the minimum wage would obviously run counter to competitiveness objectives.

We agree with the points raised by others on the need to press ahead with financial sector liberalization sooner rather than later. We would add our concern over the National Provident Fund's role in direct consumer lending and, in light of this activity, its exclusion from the Financial Institution's Bill. We are not convinced that moral suasion regarding the National Provident Fund's lending activities is a credible substitute for more transparent rules and oversight. More broadly, we question the appropriateness of this activity for a pension fund.

Finally, we appreciate the three country presentation provided by the staff. It provides a helpful basis for comparison and puts the problems and successes of these island nations, as well as the Fund's advice, in better perspective.

The staff representative from the Southeast Asia and Pacific Department said that the Polynesian Airline's debt had been a heavy burden on the budget in 1994/95. That budget had been revised, to cut other expenditures and to allow the resulting savings to be used to service the airline's debt. In 1995/96, when the debt burden of the Polynesian Airlines had fallen, much of the budget deficit would be financed through concessional borrowing. However, in the balance of payments statistics, the airline's debt had been financed through the capital account. At the time, the current account had been in surplus, owing to the strong performance of remittances and the earnings from export processing, which had offset the trade deficits.

The staff preferred that interest rates be decontrolled and had advised the authorities that, even prior to introducing auctions, they should raise the ceiling on loan rates, the staff representative pointed out. At a time when they were pursuing an easier credit policy, the authorities had argued against any action that might raise interest rates. The staff had accepted that argument, provided that the auctions were introduced as scheduled. In its second-best scenario, the staff envisaged that interest rates would be liberalized and quantitative credit controls freed following the start of the auctions, if not simultaneously.

Mr. O'Connor commented that, if auction rates were to be a useful signal, they had to be based on market prices in banking markets, where there would be some trading in cash to help fund the auction purchases.

The staff representative said that the staff agreed with that point, which was why she had referred to the second-best policy above. The level at which market interest rates would settle would be constrained at the beginning of the auction regime by the fact that the interest rate had been fixed previously at 12 percent.

Debt and debt servicing had been substantial in 1994, when the Government had assumed the debt of the Polynesian Airlines, the staff representative stated. Excluding airline debt, the overall debt had stayed constant at about 100 percent of GDP; debt-service payments would have been modest in the absence of the airline debt, given that most other debt was concessional. The medium-term scenario accounted for the fact that the airline debt was being rescheduled through to 2000. The staff estimated that, by 1999, the debt-service ratio would fall to about 7-8 percent of GDP. The staff would continue to advise the authorities not to incur private debt at commercial rates.

Mr. Waterman said that fiscal policy was a key influence on Western Samoa's performance, given the economy's current stage of development and the fact that it was a small island economy. He had been struck by the country's level of taxation compared to its income level; even though there might be some scope for further rationalization of taxes, he agreed that much emphasis had to be on expenditure restraint. His authorities needed to proceed with their privatization program. In that connection, they were working on measures to improve the operations of Government generally.

The authorities were moving in the right direction to deregulate financial markets, but were moving slowly because of earlier unfavorable experience with such reform, Mr. Waterman explained. While one could question the sequencing of the reform, it was not unusual for a country to sell Government securities first, then deregulate bank lending and deposit rates second, as had been the case in Australia. He believed that the Financial Institutions Bill would apply to nonbank financial institutions, including the National Provident Fund. It was certainly questionable whether such a provident fund should be centrally involved in consumer lending; perhaps the need for such involvement would diminish as the financial sector became more developed. There were only two private banks in Western Samoa, although a license for a third bank has been issued.

It was vital for a highly vulnerable economy such as Western Samoa to maintain a high degree of competitiveness, Mr. Waterman emphasized. Accordingly, he would ensure that Directors' comments on the proposed increase in minimum wages would be conveyed to the authorities.

The Acting Chairman made the following summing up:

> Executive Directors were in broad agreement with the staff appraisal. Directors commended the authorities for having addressed the financial crisis of Polynesian Airlines, tightened financial policies, and steered the economy to a more comfortable position. Output growth had recovered. Inflation was back in the low single digits, and international reserves were adequate. Priority now needed to be given to consolidating these gains through the careful management of fiscal and monetary policy, so that a robust foundation of macroeconomic stability could be created for medium-term growth.
>
> In this context, Directors saw risks in the budgeted rebound in Government expenditure, and recommended a tightening of fiscal policy for 1995/96. Directors particularly emphasized the importance of improving tax collections, trimming expenditures within a well-designed system of expenditure cuts, and undertaking civil service reform. This tighter fiscal stance would allow adequate credit for private sector activity and better sustained economic recovery. Directors gave priority, also, to the liberalization of the financial system through the start of auctions of central bank securities. Directors urged the acceleration of liberalization and the amendment of the Financial Institutions Bill to strengthen supervision.

Directors indicated that the main challenge over the medium term will be to raise domestic savings, enhance the contribution of the private sector, and overcome long-standing structural constraints to output expansion and diversification. The authorities' medium-term goal of fiscal consolidation had a key role to play in this regard, and Directors stressed that there was little scope for slippage. Directors also saw the need for bold structural initiatives, including accelerating the restructuring of the still large public enterprise sector through privatization and other measures, reducing institutional barriers to productive land use, and phasing out price controls.

Directors observed that maintaining a competitive economy was also key to a strengthened medium-term outlook. They stressed the need for restrained financial and wage policies related to productivity developments to support structural reforms and maintain the country's competitive position.

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

2. <u>KIRIBATI - 1995 ARTICLE IV CONSULTATION</u>

The Executive Directors considered the staff report for the 1995 Article IV consultation with Kiribati (SM/95/205, 8/16/95). They also had before them a background paper on recent economic developments in Kiribati (SM/95/277, 10/19/95).

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In recent Article IV consultations with the three countries, Executive Directors underscored the importance of maintaining macroeconomic stability while strengthening medium-term growth prospects--through a broad range of structural reforms. In particular, emphasis was placed on promoting private sector activity through the consolidation of the public sector, upgrading of infrastructure, and removal of institutional constraints.

Continued disappointing performance with respect to output growth and diversification reflects in large measure slow progress in implementing structural policies. In each country, little has been achieved in restructuring the civil service or reforming the land tenure system. Public enterprise reform, including privatization, has been initiated but progress has been sluggish. Efforts have been made to streamline investment procedures but, despite selective fiscal incentives, inflows of foreign investment have not been sustained. The area in which there have been significant improvements in all three countries is the tax system; also, policies to liberalize the financial system have been undertaken in Fiji and Western Samoa.

Following the adoption of a structural adjustment program in the late 1980s, Fiji had made significant strides in lowering import tariffs and removing quantitative controls, moving toward broad-based indirect taxes, and liberalizing the financial sector and improving monetary management. However, little has been accomplished in the last few years, and, in particular, public enterprise reform has yet to gain ground. Fiji's economic prospects are also clouded by political uncertainties, which have resulted in a persistent lack of confidence, continued outflows of skilled labor, and a decline of private savings and investment.

With less-developed institutions, Kiribati's capacity to implement structural policies is modest compared with the other two countries. During the short time span since the country joined the Fund, policy has focused on strengthening the legal and institutional framework. Thus, progress in implementing reform measures has been limited to taking initial steps toward a more efficient tax system, and adopting a framework for public enterprise reform. The attainment of higher output growth has also been hampered by inadequate infrastructure, development of which is restrained by the capacity to implement the public investment program effectively.

Implementation of reform policies has been uneven in Western Samoa, but gains have been made in restructuring public enterprises--including most recently the financially stricken national airline, introducing the value-added and general sales tax, and preparing groundwork for indirect monetary control. Negative growth rates during 1990-94 highlight the economy's vulnerability to natural adversities, but prospects for stronger performance could improve in light of recently renewed momentum in the privatization program and foreign investment in a few large projects.

While preserving financial stability remains central to Fund staff advice to the three Pacific island countries, emphasis has increasingly been given to efforts to address structural barriers to more rapid growth and diversification. Toward this goal, technical assistance to the region has been intensified, with a focus on institutional building and fiscal and monetary management. In this regard, the establishment of the Pacific Financial Technical Assistance Center has greatly facilitated effective and timely provision of advice for the past two years. The objective of expanding growth potential is shared by the World Bank, the Asian Development Bank, and key bilateral donors, which have also provided substantial financial and technical support to upgrade infrastructure and institutions, strengthen manpower, and develop key sectors.

Mr. Waterman made the following statement:

The staff report is both candid and straightforward and my authorities are in broad agreement with the appraisal. Kiribati continues to suffer from a narrow production base, lack of skilled manpower, weak infrastructure, and geographic isolation. In recent years, policies have been reasonably successful in contributing to financial stability as reflected in the relatively low and stable inflation rate, and in the surpluses in the fiscal and external sector positions, but growth has remained low.

The Government which took office in October 1994 adopted a more expansionary fiscal stance in 1995 with a view to stimulating growth. The 1995 budget provided for substantial increases in both current and development expenditures to meet needs in the social sector and in respect of infrastructure. Part of the budget increase is also for one-off payments including "rescue payments" to a number of public enterprises that were facing financial crises. A pre-condition to these payments is the improvement in the structure and management of the enterprises to ensure their financial viability in the future in line with the focus on the corporatization and commercialization of such enterprises prior to privatization.

In line with the staff advice, my authorities are now taking steps to tighten fiscal policy. Specific actions include adjustments in development expenditure according to the availability of external resources, a freeze on hiring, and cuts in travel and nonessential administrative expenditures. The savings from these measures, however, are expected to be modest in 1995. For the 1996 Budget, the Cabinet has agreed to substantially reduce the expenditure ceiling to a more sustainable level and to limit the drawdown in the RERF for operational budget support to a level that will allow the fund's per capita value to be maintained. There will be no further wage increase in the 1996 budget.

As had been noted in the report, per capita income has been declining in real terms. Thus, the principal challenge for policy remains the attainment of a higher but sustainable rate of economic growth. The potential for higher growth depends importantly on developments in the major activities of copra production, fishing, and tourism.

Copra production could be improved further in the medium to long term through replanting and this will be intensified in the future. Better collection and marketing arrangements to cut costs and obtain higher prices will be implemented. Diversification into higher value added products will also be explored.

In the marine sector, higher growth could be achieved through greater local participation in the harvesting of the resources. There is potential to increase output through joint ventures with established foreign companies and intensified efforts to attract foreign partners, especially for long line fishing for the high value market.

In the tourism sector, there is potential to increase visitor arrivals especially in the Northern Line Islands. A proposal by a foreign private airline company to provide more regular service to the islands has been approved by the Cabinet and the operation is expected to start in December this year. A planned increase in subregional airline services for Kiribati, Marshall Islands, Nauru, and Tuvalu will also improve air links and help the development of tourism in the Gilbert Group. Tourism marketing will be emphasized.

Fund technical assistance had been very useful in the past and my authorities place great value on continuing Fund advise and on the support of the international community to their efforts at strengthening the Kiribati economy.

Ms. Glennerster made the following statement:

On Monday this board discussed the response of growth and investment to adjustment (EBM/95/107, 11/13/95). I would like to draw on the conclusions of that discussion to examine the issue of slow growth in Kiribati, despite the relatively good performance in achieving macro stability.

One of the conclusions of Monday's discussion was that growth and investment sometimes took several years to pick up after a period of adjustment. Uncertainty caused the private sector to delay investment decisions. Consistency and sustainability of macro policies were seen as a vital element of promoting growth and investment.

Several Pacific Islands must represent outliers on any cross country regression of growth and investment against measures of macro stability. Kiribati, would probably be the furthest outlier of them all.

Kiribati has a long history of fiscal prudence - rarely spending the investment income generated by the Revenue Equalization Reserve Fund.

Monetary and exchange rate policy are appropriate for a country of its size. Monetary union with Australia has delivered moderate levels of inflation--particularly when compared to other developing countries.

Yet growth, as the staff and Mr. Waterman explain, has been painfully slow. Real per capita income has in fact fallen.

The oddness of this result is underlined by that fact that we would expect poorer countries, in general, to grow faster than richer ones as they are able to exploit existing technologies.

The answer to this conundrum probably lies, as the staff suggest, in high transport costs, economic isolation and structural rigidities. (Although you might think that high transport costs would effect the level of income in a country rather than the rate of growth.) There is increasing evidence of the need for a critical mass of structural reforms before growth can take off (another theme of Monday's discussion). It may be that Kiribati has not yet reached this critical mass.

The major structural blocks to growth in Kiribati appear to be the predominant role of the public sector in the formal economy and problems with land tenure--problems which Kiribati has in common with a number of other islands--including Western Samoa. I was therefore disappointed to read that the new Government has decided to slow the process of privatization.

I wonder whether, in addition to these structural issues, there is an argument for saying that fiscal policy has in the past been too prudent (although I tremble at making what might be considered a heretical statement in this board).

There seems room for using more of the investment income from the Reserve Fund for good development projects. The staff has mentioned the lack of institutional capacity as a constraint but the donor community has attempted to substitute for this lack of technical know how in developing projects and there have sometimes been problems, I understand, from a lack of current expenditure to support projects. While the new Government is planning to use more of the income from the Reserve Fund, much of this will go on increased salaries and expansion of employment in the public sector. Given that the predominance of the public sector is part of the problem, this is not an appropriate use of the Fund.

On a related point, I was concerned to see that the Government had been providing guarantees to public enterprises. I would have thought that a look across the water to Western Samoa would have been sufficient to warn of the risks of such a policy.

Finally I would like to commend the staff on a paper which set out the issues exceptionally clearly in only nine pages of text.

Mr. Oya made the following statement:

I commend the staff for having prepared a very concise and well organized paper. I agree with the thrust of the staff's analyses and recommendations, and I would urge the authorities to take the staff's recommendations very seriously. In order to avoid a repetition of the staff's appraisal, I will make just a few comments.

First, I fully agree with the staff that the newly adopted fiscal policy is excessively expansionary and unsustainable over the medium term. In addition, I am concerned that the authorities are giving priority to expanding current expenditures while indicating their readiness to cut development expenditures. Given the insufficient infrastructure in Kiribati, I believe that the authorities should give more priority to development expenditures and be ready to cut current expenditures as necessary in order to restrain the fiscal deficit to a sustainable level.

Second, I agree with the staff that the key to the achievement of higher economic growth over the medium term is to increase foreign direct investment. The authorities should make every effort to attract such investment, in particular by improving the legal framework.

In addition to increasing foreign direct investment, marketing is important as well. For example, newly constructed luxury hotels will not be able to attract tourists unless they are adequately advertised. Actually, Japanese tourists, for instance, know almost nothing about Kiribati and go to other South Pacific islands even though Kiribati is one of the closest islands to Japan. I believe Kiribati has substantial potential to attract tourists, especially from Japan, if it succeeds in marketing what it has to offer, as well as building the necessary infrastructure.

With these remarks, I wish the authorities well and every success in the future.

Ms. Laframboise made the following statement:

First, I appreciated the very concise and well-written staff report.

It would appear to be a very opportune moment for the Board to be reviewing economic policy in Kiribati.

That is, I agree fully with the staff recommendations and have serious concerns about the recent change in policy direction; in addition, I would say that the consequences of the path upon which the authorities are embarking could be much worse than the staff has indicated. I would like to add some general remarks.

From exposure to the experience of some members of our constituency, we can empathize with the Government's frustration of pursuing prudent financial policies year after year without achieving payback in terms of higher growth or investment. However, the appropriate solution is clearly not contained in the authorities' current strategy. Kiribati is in the classic development trap, the hope for which lies in raising investment and productivity in order to propel it out of the no-growth circle.

In Kiribati's case, the lack of influence over monetary policy makes fiscal policy the only macroeconomic tool to maintaining financial stability--a prerequisite for successful development; however, the key to escaping the low growth cycle lies in structural reform. The failure to implement meaningful or thorough measures in the structural sphere is the reason for failure to attain stronger economic growth and higher per capita incomes. Going on a consumer spending spree will only exacerbate the present stagnation, and jeopardize the healthy financial foundation established after years of careful management.

In this sense, I agree with the staff that the plan to raise current spending to 80 percent of GDP in 1995 from 55 percent in 1993 is very unwise. Increasing expenditure in itself would not be inappropriate if the type of spending were productive, and if offsetting measures were followed. However, considering that none of the increase this year will provide a sustainable impetus to growth or investment, the Government is wasting a valuable opportunity.

For instance, what is the economic rationale behind a 47 percent increase in wages? This is likely to lead to a temporary surge in demand and inflationary pressures, and will have very negative consequences for external competitiveness. And raising social spending is a worthy pursuit, but not if it is poorly designed and unsustainable.

Instead of spending money on the equivalent of instant gratification, the Government needs to take bold structural measures which will create an environment receptive to market incentives and conducive to investment. They could get the ball rolling by identifying key growth sectors and worthy investment projects in the context of a well targeted public investment program. Drawing on foreign assets is not undesirable provided the potential return on the investment justifies the cost--after a well-articulated investment program, drawing on the Revenue Equalization Reserve Fund would make sense since it would be a productive use of precious savings.

A good start would be to reform land ownership laws, free administered prices and impose budget discipline on state-owned enterprises. They should then privatize some state companies to reduce the dominance of the state in the economy. The civil service should be reduced and structured with a view to improving the island's administrative capacity. Technical assistance would be valuable in this field, but not before the appropriate conditions are established.

Most of these points are well articulated in the report--Kiribati is at an important juncture. From the experiences of some small island members of our constituency, avoiding tough structural policies but losing patience with stability policies and succumbing to current spending temptations has resulted in imbalances with high medium-term costs which entail a protracted effort to correct.

Finally, on monetary policy, the staff feels the authorities should continue the present arrangement "until monetary management skills and the financial market are developed." While I agree with the first part of this statement, I am not sure what the staff has in mind by the second part. Do they foresee down the road issuing a separate currency and setting up a central bank and financial market? Even if Kiribati followed the best structural and fiscal policies, I am not sure that would be the best route. A simple monetary arrangement--such as a more formal version of the current system--would appear appropriate.

I welcome the staff's views on this.

Mr. Kyriacou made the following statement:

Economic developments in Kiribati have been mixed in the recent past. On the positive side, inflation has remained relatively low, the balance of payments performance has been solid and the fiscal position, up until 1994, has been very conservative. On the negative side, however, growth, which in general fluctuates with climatic conditions, remains subdued and constitutes a major problem and challenge for the authorities. Furthermore, the recent dramatic deviation from the conservative fiscal policy stance, as reflected by the sharp deterioration of fiscal balances is particularly worrisome and casts doubts about the future economic prospects.

As the concise staff report covers sufficiently and in a balanced way the issues Kiribati is faced with, this statement focuses on the recent regrettable developments in fiscal finances and makes a point on the delays in the provision of data and other relevant information to the Fund.

The role of fiscal policy as a pillar for macroeconomic stability is particularly important in Kiribati, in view of the monetary union with Australia. It is therefore for this reason that the new Government's "major break with past conservatism" as regards fiscal consolidation is particularly regrettable and worrisome. As the staff notes, a 47 percent increase in wages has been granted by the new Government which took office in October 1994. It should be noted that this increase has been granted at a time where growth in per capita income is decreasing. Partly as a result of this development, the 1995 budget deficit is expected to deteriorate from a surplus of 24 percent to a deficit of 6 percent.

> The authorities, as indicated in Mr. Waterman's useful statement, are now taking steps to tighten fiscal policy, mainly as regards the 1996 budget. Even though these steps are welcome, an ambitious and optimistic observer might have expected that for any remedial measures to be effective, they should be as dramatic as the original slippage. The staff's comments on how far these measures go in alleviating the situation would be appreciated.
>
> Finally as regards the provision of data and other relevant information to the Fund by Kiribati, there seems to be a major problem as information of vital importance could be provided to the staff with significant delays. Could the staff inform the Board on whether any steps are taken to improve data provision to the Fund?

The staff representative from the Southeast Asia and Pacific Department said that the slow growth rate over the preceding 10 to 15 years had resulted mainly from insufficient investment, particularly in infrastructure development. The main source of capital expenditure had been donor grants; but those grants had also consisted of substantial recurrent expenditures, which were needed to maintain existing projects. Partly reflecting their lack of administrative capacity, the authorities had no viable, well-designed public investment programs with clear medium-term priorities. More technical assistance would surely be needed in that regard; the authorities would make progress over the medium term in designing an investment plan.

The authorities had taken several steps to contain current expenditures--particularly nonessential expenditure--and had frozen existing vacancies and reduced the number of new hires, the staff representative observed. While those measures would have a modest overall impact in 1995, the authorities were clearly determined to cut current expenditure in 1996: the Minister of Finance planned tentatively to cut current spending by 10-15 percent at least. It remained to be seen whether a cut of that size would be feasible; but if it were achieved, the fiscal position would strengthen substantially over the medium term.

Regarding Kiribati, the current monetary arrangements were working well, having effectively anchored macroeconomic policy, the staff representative stressed. The staff and authorities therefore believed there was no pressing need to change current monetary arrangements. They recognized that they lacked the staff, institutional capacity, and experience to establish a monetary board or central bank. It remained the case, however, that the current monetary arrangements could be transitional: at some point, Kiribati might consider establishing a monetary authority. But achievement of that objective would depend on how much progress the authorities made in addressing their current constraints.

Mr. Abbott said he would perhaps disagree with the staff's advice on current monetary arrangements. He did not know what it would cost to establish a monetary authority in a country with a population of 176,000 people and per capita income of under $1,000. For argument's sake, the Fund would probably have to recommend a monetary consultant, perhaps costing $200,000 a year; and perhaps ten staff would have to be hired for local salaries of $20,000 each. He queried why the Fund would encourage such a small country to set up institutions that might lead to the creation of a central bank: the advice did not seem to be based on economic criteria, questions of bureaucratic resource allocation, or on what was known about monetary arrangements generally. Kiribati needed the simplest form of monetary arrangement possible--whether a monetary union or currency board--requiring little administration.

Ms. Laframboise said that it had seemed the staff believed the ultimate monetary goal for Kiribati should be the creation of a central bank and/or the issuance of a separate currency. She queried whether the benefits of issuing a separate currency would outweigh the costs.

The staff representative from the Southeast Asia and Pacific Department commented that the staff fundamentally favored the existing monetary arrangement because there was at present insufficient institutional capacity to manage a separate currency, and because it had worked well as an anchor for economic policy. He agreed that, while there might be seigniorage gains from introducing a new monetary board, those would easily be offset under current circumstances by administrative costs of managing the board, particularly if the Government had the necessary skills to manage the new institution. Furthermore, while the greater flexibility afforded to monetary and exchange rate policy by having one's own currency could be useful, in the case of Kiribati, it was not certain how effective a separate monetary policy would be in the long run. Nonetheless, Kiribati might not fully exclude the possibility of having its own currency in the long run, to the extent that sufficient managerial and institutional capacity had been accumulated and the financial market had fully developed. Until such a situation had emerged, the current monetary arrangement would remain the best option.

A second staff representative from the Southeast Asia and Pacific Department emphasized that the staff appraisal stated clearly that the staff agreed with the authorities' intention to retain the current monetary arrangement.

In response to a question from the Acting Chairman as to whether the staff believed that the authorities should have the goal of establishing a central bank, the second staff representative said that the staff would have to consider the appropriate long-term arrangement.

Mr. Abbott said that the Fund could present clearer advice to Kiribati. He would simply recommend that the authorities adopt the simplest possible monetary arrangement, not a central bank. He doubted that seigniorage could pay for an expatriate monetary advisor.

While there were extremes in how flexible one could allow exchange rates to be, there was no theoretical or practical basis to seek an independent monetary policy for a country as small as Kiribati, Mr. Abbott stated. There might be other arrangements that the authorities could consider, such as one in southern Africa, where the Republic of South Africa had paid a neighboring state for allowing the South African rand to circulate within that country. Perhaps there could be a similar arrangement between Kiribati and Australia.

Ms. Laframboise said that she agreed that the gains from seigniorage would be marginal. In view of experience in other countries, it was more likely that the flexibility afforded by an independent monetary policy would work against Kiribati achieving its long-term goals. She did not favor an orthodox central bank in the country in the long term, and believed that the current arrangement was the optimal one in the short term.

Mr. Waterman said that his authorities clearly had been frustrated by the lack of progress in recent years. Despite their relatively prudent policies, growth had been minimal and per capita income had declined. While macroeconomic policy might have been excessively tight in the past--the authorities neglected needed repairs, maintenance, and some infrastructure development--it had become excessively loose in the previous year, particularly wage policy. The authorities knew that they had to adjust fiscal policy; their policy statements had been appropriate, but it remained to be seen how quickly they could restore fiscal balance.

Given its comparative lack of economic advantages, it was vital that Kiribati maintained its competitiveness and ensured that it had an efficient public sector, Mr. Waterman stressed. The Asian Development Bank had been helping the authorities to increase the public sector's efficiency, improving decision making and preparing enterprises for privatization. A country such as Kiribati had to accept that there were probably limits to the real income levels that it could achieve or sustain: it had to ensure that it made no unnecessary policy mistakes, and took advantage of the strengths that it did have by developing sectors in which it had some comparative advantage, such as basic agriculture, fishing, and tourism. It could also address a typical problem facing many island economies--the land tenure system, and its positive or negative impact on private investment.

He agreed strongly with Mr. Abbott's comments on the monetary arrangements, Mr. Waterman indicated. While he doubted whether the Australian dollar was an appropriate one for the authorities to use and whether it would benefit them in the long term, the costs and complications for a small economy of setting up its own central bank and issuing its own currency would be excessive. It was unclear how much seigniorage might be involved, and whether any gains from seigniorage could cover the cost of shipping notes and coins to Kiribati from Australia. Perhaps his Kiribati authorities could raise that question with Australia.

For a country such as Kiribati, it was vital for the authorities to focus on fiscal and public enterprise data, Mr. Waterman remarked. The national accounts data were not as important, because one could get a good impression of real performance simply by observing the main activities in the economy.

The Acting Chairman made the following summing up:

Executive Directors broadly agreed with the staff appraisal.

Directors commended the authorities for containing inflation and maintaining a strong balance of payments position, but observed that economic growth had remained low. They stressed that the central challenge for the authorities was to promote higher growth and diversify the production base while maintaining financial stability.

Directors noted with concern that the 1995 budget had assumed an expansionary stance, marking a major departure from the past. Directors considered that the budgeted increase in current expenditure was excessive and, if fully implemented, entailed a risk of eroding fiscal stability over the medium term. They urged the authorities to continue their efforts to restrain nonessential current expenditures in the final months of 1995. They urged that priority be given to development expenditures in view of the weak infrastructure. They also urged the authorities to take further measures in the context of the 1996 budget to tighten fiscal policy.

Directors observed that achieving a critical mass of structural reforms was essential to economic take-off. In that context, they noted that improvements in infrastructure were needed, and stressed the importance of strengthening the capacity to implement a well-targeted public sector investment program. They also observed that the improved efficiency of public enterprises and greater private sector participation would be a prerequisite to accelerate economic growth, and concern was expressed about the recent slowing of the privatization process. While supporting the authorities' emphasis on commercialization as a first step toward public enterprise reform, they encouraged the authorities to adopt a more determined approach to privatization. In this context, they emphasized the potential role of foreign direct investment and underscored the need to eliminate regulations that impede its inflow. Some speakers also expressed concern about the provision of public guarantees to public enterprises, noting the negative experience in other countries in the region.

Directors welcomed recent steps taken to strengthen management of the Revenue Equalization Reserve Fund. Directors felt that some increased use of RERF resources to finance development expenditure would be appropriate, provided that such expenditures were productive.

Directors considered that Kiribati's exchange system, involving the use of the Australian dollar as the legal tender, was appropriate to its economic situation and had also delivered a relatively low level of inflation.

Directors stressed the need to further improve the quality, coverage, and currentness of macroeconomic data.

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

3. FIJI - 1995 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1995 Article IV consultation with Fiji (SM/95/283, 10/23/95). They also had before them a paper providing background material on Fiji (SM/95/288, 11/6/95; and Cor. 1, 11/14/95).

The staff representative from the Southeast Asia and Pacific Department made the following statement on Fiji, Kiribati, and Western Samoa:

This statement presents additional information on Fiji's budget for 1996, which was tabled in Parliament on November 10. It also compares selected structural features of Fiji, Kiribati, and Western Samoa, and policies to promote economic growth--the key policy challenge in all three countries.

On November 10, the Minister of Finance and Economic Development presented to Parliament the Government's 1996 budget proposals, which envisage a further widening of the overall budget deficit to about 3 percent of GDP. Total revenue and grants are projected to increase slightly while total expenditure would increase by about 1 1/4 percent of GDP, mainly on account of a higher allocation for capital spending and an initial allocation of F$20 million (3/4 of 1 percent of GDP) to recapitalize the National Bank of Fiji.

The revenue measures proposed in the budget, which consist mainly of adjustments in import duties on various items, are broadly revenue neutral. However, the budget also proposes an enhancement of certain fiscal incentives to promote export-oriented industries and tourism. On the expenditure side, current expenditures are projected to remain unchanged as a share of GDP in 1996. However, the budget contains some measures that could have a longer-term impact including a freeze on the size of the civil service; the adoption of accrual accounting system to improve financial management; and the introduction of a merit system for pay increases.

While the staff has not had an opportunity to discuss the budget with the authorities, the staff's preliminary view is that the 1996 budget appears to represent a further departure from the medium-term objective of fiscal consolidation and could rekindle inflationary pressures or weaken the external position. The staff would therefore encourage the authorities to monitor closely price and balance of payments developments with a view to taking pre-emptive measures to preserve the macroeconomic gains of the past two years.

The three economies vary considerably in terms of size, institutional structure, and level of development, with Fiji at one end of the spectrum and Kiribati at the other (see Annex). Nonetheless, they share many common features and policy issues, and, taken together, they provide a regional perspective on the development problems facing the small Pacific island countries.

The single most important problem faced by the three countries is the chronically weak--or even negative--output growth that is also highly vulnerable to external disturbances. By contrast, financial stability has been broadly maintained, and although there were recent periods when lax financial policies contributed to inflationary pressures or external imbalances, such lapses in policy stance appear to have been brought under control.

The public sector in the three countries is extensive and is a major source of formal sector employment and income--a counterpart of which is a generally undeveloped private sector. Government expenditures in Kiribati and Western Samoa are particularly large, reflecting massive infrastructure needs. Fiji relies mostly on tax and other domestic revenues to finance expenditures, while Kiribati and Western Samoa also utilize substantial amounts of foreign grants. Bank borrowing in all three countries has been relatively small.

Fiji and Western Samoa established their central banks in 1984, and their currencies are pegged to baskets of their major trading partners' currencies. The financial sector in Fiji is fairly developed, and monetary policy is conducted through open market operations in a growing interbank market. Western Samoa's financial sector is less mature, and indirect instruments of monetary control are in the process of being introduced. Kiribati uses the Australian dollar as its national currency, and the Government has limited influence over monetary developments.

Trade regimes in all three countries are relatively open. Exports are concentrated in a few commodities in all these countries, but the structure of their balance of payments differs. Fiji's import dependence is relatively low; merchandise exports and tourism account for the bulk of its foreign exchange receipts, and inward transfers are small. By comparison, Kiribati and Western Samoa rely heavily on private remittances--as well as official grants--and Kiribati receives substantial income from its foreign financial assets. Growing tourism and export processing activities in Western Samoa have significantly strengthened the country's ability to earn foreign exchange.

In recent Article IV consultations with the three countries, Executive Directors underscored the importance of maintaining macroeconomic stability while strengthening medium-term growth prospects--through a broad range of structural reforms. In particular, emphasis was placed on promoting private sector activity through the consolidation of the public sector, upgrading of infrastructure, and removal of institutional constraints.

Continued disappointing performance with respect to output growth and diversification reflects in large measure slow progress in implementing structural policies. In each country, little has been achieved in restructuring the civil service or reforming the land tenure system. Public enterprise reform, including privatization, has been initiated but progress has been sluggish. Efforts have been made to streamline investment procedures but, despite selective fiscal incentives, inflows of foreign investment have not been sustained. The area in which there have been significant improvements in all three countries is the tax system; also, policies to liberalize the financial system have been undertaken in Fiji and Western Samoa.

Following the adoption of a structural adjustment program in the late 1980s, Fiji had made significant strides in lowering import tariffs and removing quantitative controls, moving toward broad-based indirect taxes, and liberalizing the financial sector and improving monetary management. However, little has been accomplished in the last few years, and, in particular, public enterprise reform has yet to gain ground. Fiji's economic prospects are also clouded by political uncertainties, which have resulted in a persistent lack of confidence, continued outflows of skilled labor, and a decline of private savings and investment.

With less-developed institutions, Kiribati's capacity to implement structural policies is modest compared with the other two countries. During the short time span since the country joined the Fund, policy has focused on strengthening the legal and institutional framework. Thus, progress in implementing reform measures has been limited to taking initial steps toward a more efficient tax system, and adopting a framework for public enterprise reform. The attainment of higher output growth has also been hampered by inadequate infrastructure, development of which is restrained by the capacity to implement the public investment program effectively.

Implementation of reform policies has been uneven in Western Samoa, but gains have been made in restructuring public enterprises--including most recently the financially stricken national airline, introducing the value-added and general sales tax, and preparing groundwork for indirect monetary control. Negative growth rates during 1990-94 highlight the economy's vulnerability to natural adversities, but prospects for stronger performance could improve in light of recently renewed momentum in the privatization program and foreign investment in a few large projects.

While preserving financial stability remains central to Fund staff advice to the three Pacific island countries, emphasis has increasingly been given to efforts to address structural barriers to more rapid growth and diversification. Toward this goal, technical assistance to the region has been intensified, with a focus on institutional building and fiscal and monetary management. In this regard, the establishment of the Pacific Financial Technical Assistance Center has greatly facilitated effective and timely provision of advice for the past two years. The objective of expanding growth potential is shared by the World Bank, the Asian Development Bank, and key bilateral donors, which have also provided substantial financial and technical support to upgrade infrastructure and institutions, strengthen manpower, and develop key sectors.

Mr. Ismael made the following statement:

After a cyclone-related slowdown in 1993, the Fiji economy recovered strongly by 4.5 percent in 1994, with record performances in the country's two major industries, namely, sugar and tourism. As a result, foreign exchange reserves have increased to a comfortable level of over 4 months of imports. Moreover, this good performance was achieved without any pressure on inflation. In fact, the average inflation rate declined to a historical low of 0.6 percent against 5.2 percent a year ago, aided by low imported inflation and smaller wage increases.

Economic growth in Fiji is expected to moderate somewhat to 2.2 percent in 1995, reflecting lower sugar production after a record harvest in 1994. However, as sugar output returns to more normal levels, GDP growth is expected to recover to 2.9 percent in 1996, despite projections of slower growth in tourist arrivals. As the outlook for domestic demand remains subdued, inflation is forecast at only 2 percent in 1995 and 1996. The external position is expected to improve further with a continued build up of reserves to slightly above 5 months of import cover by the end of 1996. Similarly, Fiji's external debt position is also expected to continue to improve, with the public external debt to GDP ratio declining from 9.9 percent in 1994 to 8.9 percent by the end of 1995.

The Fiji authorities are in full agreement with the views expressed in the staff report. In particular, the monetary authorities are maintaining appropriately tight financial policies that will consolidate price and external stability. Developments on the external and domestic front are being monitored closely to ensure that credit demand by the private sector are being adequately met but commensurate with domestic economic conditions. Toward this end, the authorities will continue to address the high level of liquidity in the banking system with regular issues of central bank notes and bonds to mop up any "excess" liquidity.

The authorities recognize that domestic saving and investment need to be encouraged. The low domestic inflation has created a catalytic environment for higher savings. On the investment front, the authorities are moving simultaneously on multiple fronts. First, to ease the constraint on its important tourism industry, the authorities recently announced a tax incentive package for the construction of additional hotel facilities by June 2000. Second, a further liberalization of exchange system, particularly on remittances of capital profits should further boost business confidence. Third, the authorities recognize the importance of the land lease arrangement and is moving ahead with a resolution on this issue. Fourth, the authorities are continually exploring ways that the investment approval procedure and fiscal incentives system can be streamlined. The ultimate aim is to have an Investment Act which will remove or streamline Fiji's rules and regulations on investment.

On the fiscal front, much progress was achieved in 1994, with a reduction in the budget deficit to 1.3 percent of GDP from 3.5 percent in 1993. Significantly, there has been little growth allowed in operating expenditure. However, the budget for 1996, announced last Friday, shows some widening of the Government deficit (from 2.5 percent of GDP in 1995 to 3.6 percent of GDP in 1996). Here, the Fiji authorities fully share the staff's concern on the need for further fiscal consolidation. I should point out however, that the bulk of the increase is due to one-off factors like the recapitalization of the National Bank of Fiji. Excluding the extraordinary provision of F$20 million for the National Bank of Fiji, the 1996 budget deficit would be only 2.8 percent of GDP. The slight widening of the budget deficit does not in any way imply a lack of commitment to fiscal prudence on the part of the Fiji authorities. In fact, my authorities are fully aware that an ever-growing budget deficit is not sustainable, and remain firmly committed to balancing the budget by the year 2000.

It is also important to highlight that the 1996 budget has been formulated under a scenario of weak domestic investment and modest growth forecast. The authorities have therefore attempted to reorient its expenditure toward development purposes and to key social areas like health and education. In fact, capital outlays are expected to increase by 46 percent in 1996, while operating expenditure should rise by only 3 percent. Moreover, the authorities are moving toward setting wage and salary increases based on productivity to enhance efficiency and reduce the burden on public sector wages. Finally, the financing of the budget deficit will come mainly from nonbank financial institutions and will not have a crowding out effect due to the large liquidity in the banking system and the weak demand for credit by the private sector. Furthermore, public sector indebtedness remains at a reasonable 35 percent of GDP. Legislative approval of the Public Enterprise Bill is now at an advanced stage, and is expected to be tabled for further parliamentary consideration early next year. In the meantime, plans are being drawn up for the privatization of several public enterprises, including the National Trading Corporation, the Unit Trust of Fiji and the public utilities. The authorities are continuing to push forward with the development of the capital market with the assistance of the Asian Development Bank.

Executive Directors may recall that the rumors of a devaluation prior to the announcement of the Government's budget last year caused a run on foreign reserves. The authorities moved decisively to implement measures to address the outflows and the situation returned to normal quickly. The Fiji authorities share the views of the Fund Mission and the World Bank that the use of the exchange rate as an anchor has been a source of stability to Fiji. More importantly, the authorities agree with the Fund that the country's external competitiveness since 1992 has remained generally adequate. The authorities appreciate the staff's in-depth views on the exchange rate policy. They share the staff's analysis that the key challenge to maintaining competitiveness is to keep inflation low through structural reforms, efficiency measures and a prudent macroeconomic policy package.

The situation of the National Bank of Fiji has been quickly addressed by the authorities with assistance from the World Bank. The Board of the National Bank of Fiji is now working closely with the central bank to fully implement the rehabilitation program that has been adopted. In the immediate term, the authorities are keen to see that the Bank regains its financial strength at a viable level of operation with the longer-term aim of privatization. In this regard, the implementation of the new

Banking Act was timely by strengthening the supervisory and regulatory framework of the banking system. Further discussions will be held with the World Bank on additional assistance on the recapitalization of the National Bank of Fiji and the review of the financial system.

Finally, the authorities are appreciative of the support of the Fund through its technical assistance and wishes to thank the staff for the opportunity to discuss and exchange views.

Mr. Abbott made the following statement:

Fiji keeps its finances, both budgetary and monetary, in good order. The result is macroeconomic stability. There are no significant internal or external imbalances. Inflation is very low and growth is positive--if also low.

Still, it is disappointing that growth is as low as it is. Fiji has some natural and inescapable handicaps to rapid development but it seems to be tolerating more man-made handicaps than it needs to.

Savings and investment are weak. National saving was 18.9 percent of GDP in 1989; last year it was 11.7 percent. Most of this is attributable to falling private savings rates which, over the same interval, dropped from 15.2 percent of GDP to 8.2 percent. Public saving turned up last year but has been weak in most of this same period. The medium-term scenario shows saving and investment picking up over the balance of the decade and helping to carry growth higher. This is, of course, what needs to happen but, since there is not much analysis of why the saving and investment ratios fell in the first place, I am not quite sure why we should now anticipate they will recover.

Unhelpful incentives must be part of the problem. Financial intermediation costs are very high. Savers earn 5-6 percent and borrowers pay over 11 percent. This has been a persistent problem with no indications anything in particular is being done to try to narrow the intermediation spread. More competition would help. Even if we accept that the small size of the market limits the scope for a large number of participants in local financial markets, some steps could be taken to instill more competitive pricing.

The problems at the National Bank of Fiji suggest that problems in the financial system are deeper than just a limited market. It looks very much like an intermediation tax has been being paid so a public bank could continue to make unsound loans to other public entities. Restructuring the National Bank of Fiji will deal with the unfortunate legacy of earlier weak practices. More basic reforms should follow. Better supervision is part of this but market improvements are also needed. Now that the authorities are committed to fiscalizing the large and long standing losses in the National Bank of Fiji, collateral steps should be taken to improve banking competitiveness and reduce the implicit intermediation tax.

Nothing much seems to have been done recently to improve or privatize the operations of the pervasive state enterprise sector. Their financial performance in 1994 seems to have deteriorated significantly from earlier lackluster results. I am pleased the authorities are now discussing corporatizing the activities of about 16 of these entities but privatization would be a more appropriate objective given the evident need to energize activity.

The nice econometric studies in the background paper on recent economic developments shed a little additional light on the weak growth performance in Fiji. Total factor productivity growth has been low. Just why it is low is a separate issue but, if it is, the implication is that growth will need to rely more on capital accumulation. That is why declining saving and investment rates are particular concerns.

The background papers add an important refinement of this point. Human capital formation is shown, not surprisingly, to have had an important influence on the contribution of labor to growth. Since 1987, this contribution has been declining for two reason. Military spending has increased and is crowding out spending on education. Human capital formation has slowed. Over and above this, there is a steady emigration of better educated and technically qualified Fijians. Public spending priorities need to be reexamined, with a sharper focus on the growth implications of the budgetary choices being made.

The staff paper suggests monetary policy may be a little tighter than necessary. Fiji does not have much scope for monetary activism but, even so, the staff report gives the impression policy is overly passive. Money growth has been decelerating for some time and is now increasing very slowly. If money growth were to be spurred by an expansion of international reserves, that would be fine. But, if this does not materialize, a little faster expansion of domestic credit could be accommodated within a stability-oriented monetary policy. I wonder if the staff has any suggestions about how monetary policy can be kept on an appropriately balanced path.

Mr. Prasad made the following statement:

I would like to congratulate the staff on a concise and well written report. This has been a good year for Fiji. The macroeconomic indicators are positive, with a rise in GDP growth, historically low inflation and an improved external position. To the extent that the handling of the National Bank of Fiji crisis is an indication of the determination of the authorities, and as reiterated in Mr. Ismael's statement, it is clear that the economic policies of Fiji are in good hands. If there are concerns, they relate to the elusive growth formula that we followed with much intensity on Monday. I agree with the staff recommendations as well as Mr. Abbott's remarks, and would like to make just two points for emphasis.

Firstly, is Fiji taking full advantage of the comfortable macroeconomic situation and the resultant opportunities that have become available? To quote from the background paper, "... cautious macroeconomic policies, per se, may not be sufficient to stimulate growth and investment if microeconomic policies are inward-looking, or private confidence is lacking." There are firstly the growth-restricting problems that are endemic to these island economies, as also highlighted in today's "joint" report on the three island economies. Specifically to Fiji, there are in addition, some of last year's concerns on structural matters impacting on medium term growth prospects which still persist.

I would like to draw attention to the uncertainty over investments, particularly in agriculture, where the changes proposed in the land tenure system will have a major bearing on agricultural credit patterns and investment. This is an area requiring strong policy action. We note that the authorities are moving to resolve the land lease arrangement.

With limited scope being available for diversification, I would support recommendations to provide more incentives for investment promotion, and the recent incentive package for the tourism industry should be welcome. The statement by the staff yesterday indicates that the latest budget proposals contain more such incentives. I have one question on the proposals regarding tourism; given the comparatively low hotel occupancy rate (36 to 40 percent) in the last four years, is it the construction of additional facilities that needs priority, or the utilization?

On human capital issues, I support Mr. Abbott's concerns. The staff reports draw attention to the outflow of skilled labor and professionals in the post-1987 period; even on cautious interpretation of data, the decline in skilled workers would impact adversely on growth, specially when linked with the marked reduction of expenditures on education which would eventually further reduce the availability of skilled workers.

Finally, a question on sugar. I am a bit confused by the description of sugar exports. Sugar forms 9 percent of the GDP, and 37 percent of exports (in U.S. dollars). Of this, for exports to the EU, the Sugar Protocol allows Fiji to benefit from prices which are more than double the current world prices. The preferential or "artificial price" component of these exports is around US$ 65 million per annum at present. We understand from the papers that the Uruguay Round agreements should not at present affect Fiji's access and price protection, but the decline in the internal prices in the EU would partially alter this scenario by 2000 A.D. In the absence of any major diversification in exports within the next four years, does this mean that there could be a decline of up to 15 percent of exports even if present levels of production and competitiveness are maintained? If so, what are the other implications for Fiji?

Mr. Oya made the following statement:

At the outset, I would like to commend the authorities for having achieved a good economic performance. As I have very little to add to the concise but well-focused staff report that the previous speakers commended, I will be brief.

I fully agree with the authorities' and the staff's general assessment that the current tight financial policies should be maintained in order to preserve price stability and that Fiji's slow growth should be addressed from the supply side by speeding up structural reforms.

I believe that the authorities' macroeconomic management has been generally satisfactory. However, the recently announced 1996 budget seems a little expansionary and could rekindle inflationary pressures. While Mr. Ismael's detailed explanation in his statement alleviates this concern to some extent, close monitoring of price and balance of payments developments are warranted. On the structural side there seems to be much more room for improvement. Above all, I join the staff in emphasizing the urgent need to enhance the competitiveness of some exports and diversify the economy, as Fiji's preferential access to its major markets will be reduced as a result of the Uruguay Round and regional trade agreements.

In order to ensure high sustained growth over the medium term, appropriate policies on investment promotion are crucial. In this regard, it is encouraging that there are signs of renewed confidence on the part of private investors. In addition, I welcome the authorities' initiatives in this respect, such as the recently announced tax incentive package for the construction of additional hotel facilities, which was described in Mr. Ismael's statement. However, I believe that the authorities should address the more fundamental structural issue of investment. For instance, I would urge the authorities to take prompt and resolute action to address the uncertainties surrounding the constitutional and land issues.

In conclusion, I would like to reiterate the importance of maintaining a prudent macroeconomic policy, as this is the most important basis to achieve sustained growth.

With these remarks, I wish the authorities well and every success in the future.

Miss Bessone Basto made the following statement:

We commend the Fiji authorities for the progress toward price stability, fiscal consolidation, and a more outward-looking reform strategy. However, growth performance continues to be subdued and has been, over the last decades, characterized by a very high degree of volatility, due to the country's vulnerability to external shocks; private investment has been at historically low levels over the last three years; and the pace of reform implementation has been uneven.

As emphasized by the interesting background paper, which analyses Fiji's growth performance and output behavior since the late 1960s, cautious macroeconomic policies, per se, may not be sufficient to stimulate growth and investment if microeconomic policies are inward-looking, or private confidence is lacking. This has certainly been the case in Fiji, where the lack of business confidence, reflecting uncertainty over constitutional and land-related matters, as well as the slow implementation of structural reforms, have played a significant role in undermining investment and, thus, growth performance. In light of these considerations, we agree that Fiji's low growth level should be addressed from the supply side by accelerating structural reforms, in particular those aimed at giving incentives for private and foreign investment and diversifying the economy. Tight financial policies are the appropriate environment for these reforms.

Monetary policy in Fiji is aimed at price stability, the accumulation of official reserves, and the provision of adequate credit to the private sector. In order to alleviate the burden represented by these three, sometimes conflicting, objectives, the strengthening of fiscal consolidation is required. Even though a larger budget deficit is projected for 1995 (2.25 percent of GDP), we were reassured by the staff's information that this deficit can be financed without crowding out private sector credit. Furthermore, we welcome the fact that a reorientation of expenditures is envisaged, favoring much-needed social and economic infrastructure, in order to enhance the productive potential of the economy. However, we are no longer certain that the same reassurance regarding its financing can apply to the 1996 budget, which allows for a further widening of the deficit to 3 percent of GDP. Given the likely negative effects in terms of price stability, business confidence, and private investment, associated with a higher deficit, we encourage the authorities to avoid departures from their medium-term objective of fiscal consolidation. Wage bill reduction and a greater prioritization of current expenditures should constitute important steps in this direction.

Taking into consideration the external sector's good performance in recent years and the progress with disinflation, the current exchange rate system (characterized by an exchange rate pegged to a basket containing the currencies of five major trading partners) seems appropriate. However, as warned by the staff, export competitiveness may be adversely affected in the near future, given the reduction of Fiji's preferential access to its major markets as a result of the Uruguay Round and regional trade agreements. This notwithstanding, the improvement of competitiveness should be ensured through reforms aimed at enhancing economic diversification and productivity, rather than through currency depreciation, thereby avoiding the inflationary pressures caused by the pass-through effect on domestic prices.

Ms. Glennerster made the following statement:

I would like to briefly pick up on the general theme of the discussion of the relationship between macro stability and growth and investment. Mr Abbott has pointed out that private investment in Fiji has fallen despite a relatively stable macro environment.

Mr. Geethakrishnan, in his statement for the previous discussion (EBM/95/107, 11/13/95), pointed out that political factors were often as important in providing the right environment for investment and growth as macro economic stability. Looking at the Chart 1 of the staff report, it is clear that there is a correlation between political events and the level of private investment.

Mr. Botoucharov made the following statement:

I am in broad agreement with the staff's appraisal and recommendations. I will therefore highlight only a few points. Like the staff and other Directors, I would like to emphasize that the commendable results achieved on stabilization in both 1994 and 1995 provide an excellent opportunity for the authorities to reorient the economy to a higher growth path, provided that macroeconomic stability is maintained and structural reform agenda is completed.

Concerning macroeconomic stability, I concur with the staff's view that the authorities should follow appropriately tight financial policies in order to preserve the macroeconomic gains obtained in the last years. In this respect, I am pleased to note the authorities' agreement with the staff's recommendations, and their commitment to follow policies that would secure consolidation of price and external stability, on the one hand, and would catalyze domestic saving and investment, and on the other. As regards the medium-term policy stance, it is my view that fiscal consolidation remains one of the main challenges facing the authorities. The intensified fiscal efforts in 1994 and the Government's strategy for the period 1996-2000 are promising and reaffirm the goal of medium-term budgetary balance. the staff makes it clear, however, that the Government's 1996 budget proposal departs from this objective due mainly to higher expenditures related to the recapitalization of the National Bank of Fiji. I therefore would urge the authorities to continue their policies for correction of fiscal imbalances and to restore fiscal credibility through strict adherence to the goal of eliminating the budget deficit by the year 2000. I was pleased to learn from Mr. Ismael's statement that the Fiji authorities are fully committed to fiscal prudence and to balancing the budget in the medium term.

On the structural side, I welcome the authorities' recognition of the need for further structural reforms. Apart from the positive results in the areas of trade liberalization and tax reform, less or almost no progress was secured in enterprise restructuring and in the policies on investment promotion. It is obvious that an acceleration of the structural reform efforts is needed in order to enhance the country's medium-term growth potential.

Finally, on the exchange rate policy, this chair shares the authorities' and the staff's view that the use of a nominally pegged exchange rate has been a main source of stability. I would appreciate if the staff could inform us about the recent development of the exchange rate.

Ms. Zheng made the following statement:

It is encouraging to see that Fiji's economy quickly recovered from a cyclone-related slowdown in 1993. Despite the widened fiscal deficit, the GDP growth and foreign exchange reserve have reached quite a comfortable level, with inflation at a historical low. While the persistent structural reforms in the past decade certainly played an important role in achieving these, the Fiji authorities are also to be commended for their role played in macroeconomic management. Beyond my broad agreement with the staff report and Mr. Ismael's statement, I will only mention a few points for emphasis.

On the fiscal front, the reduction of the fiscal deficit from 3.5 percent of GDP in 1993 to 1.3 percent of GDP is certainly significant. The authorities were correct to constrain any growth in operating expenditures and finance the overall deficit through the issuance of long-term bonds to the nonbank sector. The expenditure measures' restructuring, especially those in favor of infrastructure and education, will benefit long-term economic productivity. However, we are slightly concerned about the impact of this year's crisis of the National Bank of Fiji, the country's largest commercial bank. While, according to the staff, the impact of the crisis on other banks is fortunately small, the task to rescue it is still difficult. The cost of rescuing the National Bank of Fiji, between 2.5 and 3.5 percent of GDP over the next five years, will add a burden to the budget. In this regard, we are of the view that, despite the current favorable economic environment, the authorities should remain vigilant and maintain their strong commitment to fiscal consolidation. In view of the 2.2 and 2.6 percent of GDP budget deficit in 1995 and 1996 respectively, we would like to know what are the impacts of some fiscal measures, such as the tax incentive package for the construction of additional hotel facilities and the increase in the personal income tax threshold, on the fiscal balance.

Furthermore, given the weakness in aggregate demand, a recovery in private investment is needed in the medium term. This will require an improvement in fiscal performance to raise the level of national savings.

Related to the crisis issue, I would also like to reiterate the importance of strengthening the banking supervision system, or, more specifically, the mechanism to prevent the misconduct of banking business from tarnishing the credibility of banks, as this is the key to preventing crises. Anyway, we are pleased to see the authorities have taken timely and appropriate measures, including a reshuffling of management and start of a rehabilitation program. The implementation of the new Banking Act will also help improve the condition of the banking system.

Finally, we wish the authorities every success in their future endeavors.

Ms. Petana observed that the issue of land constraint was common to all three countries. The limited amount of land would always limit the potential economic growth rates of the three countries, even if they implemented all the advice given. She asked the staff and Mr. Ismael whether progress had been made in Fiji with dialogue between the Government and the customary landowners. In Western Samoa's case, for instance, such dialogue had progressed and would likely intensify: generally, the customary landowners had accepted the need for reform. However, the legal framework and institutions needed to assist the reform process were missing.

The staff representative from the Southeast Asia and Pacific Department said that the background paper had sought to explain why savings and investment in Fiji had declined to an historical low in recent years. While savings and investment had been relatively high in the 1980s, it had begun to fall late in that decade, to plummet after 1987, and had remained low ever since. That reflected the private sector's lack of confidence, which was a critical constraint to achieving faster growth in Fiji. The volatility of growth itself was explained partly by the highly adverse weather that Fiji had experienced in the early 1980s. Nonetheless, the potential growth rate in the 1990s appeared to have accelerated, given the authorities' switch from a highly inward-oriented economic strategy to a more outward-looking one. If the authorities pushed ahead with structural reforms, there was no reason why Fiji could not achieve a much more rapid growth rate over the medium term, as illustrated in the medium-term scenario.

The Government had privatized two enterprises in 1995 so far, and planned to privatize a further four in 1996 by selling part of its share in the enterprises, the staff representative stated. However, the Enterprise Bill had not been passed in the preceding session of Parliament, and had been transferred to a select committee, which was studying its implications. The Bill would be resubmitted to Parliament in 1996. It was potentially vital to the whole process of enterprise reform, because it would empower the Minister to select enterprises engaged in commercial activities and restructure them to make them more viable, either corporatizing them or by turning them into statutory bodies. The authorities regarded that as the first step in privatization.

While the fiscal deficit would increase by about 1 percentage point of GDP in 1996, nearly three-fourths of that increase would derive from recapitalization of the National Bank of Fiji, and the remaining one-fourth from higher capital expenditure, the staff representative pointed out. Given the low level of economic activity, the financing of the deficit could probably be accommodated without crowding out private sector borrowing. The staff would monitor developments to assess whether the deficit was too expansionary.

The authorities were negotiating a World Bank loan enabling them to restructure the National Bank, the staff representative mentioned. In addition to the measures described in the staff report, the authorities had divided the Bank's portfolio into good and bad loans, the latter of which would be collected and managed by an outside management unit. The authorities hoped to rehabilitate the good loans, and, of course, needed to inject capital into the Bank to that end. In 1995 so far, they had added $20 million in capital to the Bank.

The spread between lending and deposit rates was similar to that in other islands in the region, the staff representative said. The cost of funds in small island economies was typically high: currently, it was about 4-5 percent in Fiji, compared with 3-4 percent in Malaysia. There had been no controls on interest rates since 1987, so rates moved according to market demand. Interest rates had declined in the preceding two years, but not as much as was possible, as inflationary expectations had remained high. The inflation rate had averaged 6-8 percent over several years, and had only declined to 2 percent in the preceding year.

Mr. Abbott said it would be useful to have statistical evidence of higher interest rates on small island economies, because the 6 percentage point interest rate spread in Fiji seemed to be unusually high. He thought inflation expectations in the pricing of loans would have fallen by more than they had. The financial system did not seem to be responding as it should.

The staff representative from the Southeast Asia and Pacific Department commented that monetary and credit aggregates had declined sharply in the past year, but had started to grow in the preceding few months, and would probably reach a 5 percent annual growth rate by end-1995. The demand for credit was weak, reflecting weak economic activity. The staff believed the current situation was appropriate, and that the authorities should not seek to encourage more bank lending. The currency had continued to depreciate in the past few months, owing to Fiji's low inflation rate relative to partner countries, the staff representative added. The staff agreed with the current level of the exchange rate.

The hotel occupancy rate was low, reflecting the fact that higher-class hotels needed to be built to attract tourists from Japan, the staff representative confirmed. That explained why the authorities had provided a fiscal incentive in 1995 for building hotels, which they specified had to be built by the year 2000. There were some indications that the incentives had encouraged developers to accelerate building plans.

While there had been several studies with varying results on the Uruguay Round's implications for sugar exporters, they indicated on average that the price of sugar would fall in the EU by about 5-10 percent, the staff representative remarked. The overall impact on Fiji would not be substantial. The staff, even so, had encouraged the authorities to raise productivity in the sugar industry by restructuring it. The single current price for all sugarcane had fostered only marginal growth in the industry. The staff therefore had advised the authorities to price sugarcane according to quality, which they had since agreed in principle to do.

The indigenous population owned about 3 percent of the land in Fiji, most which was leased to growers, who happened to be Indians, the staff representative commented. In the next few years to the year 2004, many of those leases would begin to expire. Many growers were uncertain whether their leases would be renewed, and had been unable to borrow from banks to finance capital improvement of the land. The staff had met with the Native Land Trust Board, which had said that it was taking steps to address the problem comprehensively. The few leases that would expire in 1997 had apparently been dealt with, so the staff hoped that the overall problem would be addressed satisfactorily.

Mr. Abbott said that the property rights issue seemed to be critical to small island economies. He asked why there had been a stalemate on renewing leases, whether it had resulted from a possible opportunity for landowners to lease to other leaseholders, whether institutions simply were sluggish and unresponsive to economic incentives, and why leaseholders had not taken steps to negotiate forward contracts.

The staff representative from the Southeast Asia and Pacific Department responded that it was surely correct that property rights was an issue in all three island economies. Historically, ownership of insular land had been communal. In the case of Fiji, the Native Land Trust Board had been set up to manage the leases for the indigenous owners: there were no direct negotiations between owners and leaseholders; and the owners held their land in common. In the long term, property rights would need to be defined more clearly. Some owners believed that the rent was too low and out of line with market prices; they had delayed renewing leases in the expectation that they could farm the land themselves or negotiate the rent upwards.

Mr. Ismael added that there was a public-private-sector dialogue on the land lease issue in the National Economic Summit. He hoped that forum would be a sufficient vehicle to resolve the land issue.

A second staff representative from the Southeast Asia and Pacific Department said that the staff would heed Directors' call to be innovative in focusing on regional matters in the next round of Pacific Island consultations. Accordingly, the staff intended to focus on some key issues on a comparative basis, including the link between savings, investment, and growth.

Mr. Ismael noted the Board's concern at the apparent reversal in fiscal policy in the 1996 budget. The increase in the 1996 fiscal deficit reflected a one-time-only provision to rehabilitate the National Bank of Fiji; excluding that item, the deficit would be only 2.8 percent of GDP. The bulk of the 1996 budget was devoted to productive capital outlays, which would increase by 45.7 percent. Growth in operating expenditure had been only 3 percent; and military spending accounted for only 5 percent of total expenditures, which the authorities were committed to reducing further, after review by a defense committee. The authorities, indeed, were determined to prevent the widened deficit from becoming a trend, and were committed to achieving a balanced budget by the year 2000. To that end, they had adopted a zero growth policy for the public service, with a new merit system whereby civil service wage increases would be based on productivity. Privatization was another vehicle to downsize further the role of Government. Tax policy was being reviewed to allow rationalization and simplification of the tax system, through reducing exemptions and allowances. His authorities were committed to continuing their prudent macroeconomic and structural policies to foster strong growth and price stability.

Regarding political stability and its impact on investor confidence, his authorities considered it to be essential to eliminate the marginalization of indigenous Fijians and other disadvantaged groups in business, and to ensure that they shared equally in the fruits of economic development, Mr. Ismael concluded. The authorities were providing education, training, and soft loans to the indigenous people, to enable them to participate more fully in the economic mainstream.

The Acting Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal.
>
> Directors commended the authorities' prudent financial policies, as reflected in the prevailing low inflation and comfortable external position. However, they noted that, although the economy had recovered from the 1993 cyclone, growth had remained low, in part reflecting slowness in implementing structural reforms and the persistent lack of confidence in the private sector. Directors urged the authorities to take advantage of the favorable circumstances to raise the economy's growth rate, to accelerate the structural reforms, so that the economic growth rate could be improved over the medium term.
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> Directors considered that fiscal and monetary policies had been appropriate in 1995. However, they expressed concern over the recently-introduced 1996 budget, which projects a further widening of the overall deficit in 1996, noting that it represents a departure from the objective of fiscal consolidation and could rekindle inflationary pressures or weaken private sector confidence.
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> It was noted that the widening of the deficit in 1996 was largely due to one-off factors, and also that it may not crowd out the private sector. Nevertheless, all Directors urged the authorities to return to the goal of medium-term fiscal consolidation in order to raise national savings and make room for a needed recovery in private investment. While noting the need to improve tax administration, Directors supported the authorities' focus on reducing operating expenditures, particularly the wage bill, and shifting expenditure priorities toward more productive areas, including infrastructure, education, and training.
>
> Directors commended the authorities for their decisive handling to date of the financial crisis of the National Bank of

Fiji and urged them to take any additional measures that may be necessary to deal with the situation, so as to maintain confidence in the banking system. In this context, Directors supported current efforts to strengthen the regulatory and supervisory framework of the banking system, which should help prevent such crises in future. Directors observed that the intermediation costs were high, and this called for deeper financial reforms, especially to increase competitiveness.

In light of the satisfactory performance of the external sector and the prevailing low inflation, Directors were of the view that the current exchange rate policy remained appropriate. They observed, however, that in order to preserve competitiveness and to help the economy adapt to the challenges of a changing world trade environment, measures would be needed to restructure and further diversify the economy.

Directors encouraged the authorities to speed up structural reforms, particularly in the area of reforming public enterprises, whose performance had been lackluster, investment policies, and the labor markets, so as to improve growth prospects. These reforms would not be fully effective without a return of private sector confidence, which Directors felt could be fostered most effectively by an expeditious resolution of uncertainties over constitutional and land issues. Progress in all these areas would greatly improve the policy environment and set the stage for a sustained increase in domestic savings and investment, which is essential for the economy to move to a higher growth path.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/95/107 (11/13/95) and EBM/95/108 (11/15/95).

4. COLOMBIA - REPRESENTATIVE RATE FOR COLOMBIAN PESO

The Fund finds, after consultation with the Colombian authorities, that the representative exchange rate for the Colombian peso under Rule O-2, paragraph (b)(i), against the U.S. dollar is the rate certified to the public by the Banking Superintendency, which corresponds to the mean of the weighted averages of the U.S. dollar/peso buying and selling rates at which exchange market intermediaries have engaged in transactions. It is understood that the Banco de la Republica will continue to report to the Fund the representative rate of the Colombian peso on a daily basis, and will inform the Fund promptly of any change in exchange arrangements that may affect the determination of the representative exchange rate. (EBD/95/149, 11/8/95)

Decision No. 11109-(95/108) G/S, adopted
November 13, 1995

5. ZAMBIA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY - POSTPONEMENT

Paragraph 4 of Decision No. 11003-(95/58), adopted on June 14, 1995, shall be amended by substituting "not later than December 15, 1995" for "within five months of the date of this decision." (EBS/95/179, 11/13/95)

Decision No. 11110-(95/108), adopted
November 14, 1995

6. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 94/82 are approved.

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/95/180 (11/10/95) and EBAM/95/182 (11/13/95), and by an Advisor to Executive Director as set forth in EBAM/95/182 (11/13/95) is approved.

APPROVAL: April 14, 1997

REINHARD H. MUNZBERG
Secretary

Fiji, Kiribati, and Western Samoa: Comparative Indicators, 1994

	Fiji	Kiribati	Western Samoa
Independence (year)	1970	1979	1962
Fund membership (year)	1971	1986	1971
Population (in thousands)	784	76	167
Nominal GDP (in US$ mn.)	1,847	51	136
GNP per capita (in US$) 1/	2,360	810	950
Macroeconomic Indicators			
Average growth rate per annum (1990-94, in percent)	2.8	0.2	-2.8
Average inflation per annum (1990-94, in percent)	5.1	4.9	8.5
External current account (excl. grants, in percent of GDP)	-3.4	-5.1	-14.6
Gross international reserves			
(End period, in months of imports)	4.1	103.9	5.6
External debt (end period, in percent of GDP)	13.6	18.4	134.1
External debt-service ratio	8.8	0.2	32.7
Fiscal Structure (in percent of GDP unless otherwise noted)			
Government receipts	25.8	99.3	53.5
(Of which: external grants)	0.2	35.0	10.4
Government expenditure	27.1	102.0	65.2
(Of which: wage bill)	(11.4)	(22.8)	(14.0)
Overall fiscal balance	-1.3	24.0	-11.8
Monetary Structure			
National currency	Fiji $ 2/	Australian $	Tala
Central Bank (year established)	1984 2/	N/A	1984
Number of commercial banks	6	1	2
M2 (or bank deposits)/GDP (in percent)	52.3	57.2	39.9
External Structure			
Merchandise imports/GDP (in percent) 3/	39.3	81.1	58.7
Merchandise exports (percent of imports) 3/	66.7	18.0	4.4
Export processing (percent of imports)	...	...	6.5
Tourism earnings (percent of imports)	37.5	3.6	28.5
Inward private transfers (percent of imports)	5.0	22.0	41.1
Investment income (percent of imports)	2.5	54.0	3.6

1/ Figure for Fiji is GDP per capita; figure for Western Samoa refers to 1993.

2/ Previously Fiji pound; Central Monetary Authority of Fiji (1973-83) predated the Reserve Bank of Fiji.

3/ For Fiji, corrected for re-exports; for Western Samoa, excluding export-processing activities.