INTERNATIONAL MONETARY FUND

Minutes of Executive Board Seminar 84/4

10:00 a.m., Friday, May 4, 1984

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	L. K. Doe, Temporary
	L. E. J. M. Coene, Temporary
	G. E. L. Nguyen, Temporary
	M. Teijeiro
	M. K. Bush
M. Finaish	T. Alhaimus
T. Hirao	
	Jaafar A.
R. K. Joyce	L. Leonard
A. Kafka	
	W. Moerke, Temporary
	G. Gomel, Temporary
R. N. Malhotra	A. S. Jayawardena
	E. M. Ainley, Temporary
J. J. Polak	
A. R. G. Prowse	
G. Salehkhou	O. Kabbaj
	M. Camara, Temporary
M. A. Senior	E. Portas, Temporary
J. Tvedt	T. A. Clark
Zhang Z.	

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present

B. Legarda, Consultant. African Department: J. B. Zulu, Director; F. d'A. Collings. Asian Department: J. H. Felman, K. Saito. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; E. J. Zervoudakis. External Relations Department: J. M. Landell-Mills, I. S. McDonald, G. P. Newman. Legal Department : G. P. Nicoletopoulos, Director; Ph. Lachman. Research Department: R. R. Rhomberg, Deputy Director. Treasurer's Department: O. Roncesvalles. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. R. Abiad, C. J. Batliwalla, S. M. Hassan, H.-S. Lee, J.-C. Obame, Y. Okubo, I. R. Panday, D. I. S. Shaw, D. C. Templeman. Assistants to Executive Directors: R. L. Bernardo, Chen J., I. Fridriksson, V. Govindarajan, N. U. Haque, H. Kobayashi, A. Koné, M. J. Kooymans, G. W. K. Pickering, T. Ramtoolah, J. Reddy, D. Robinson, C. Salinas, A. A. Scholten, S. Sornyanyontr.

1. SMALL TROPICAL ISLAND COUNTRIES - AN OVERVIEW

Executive Directors, meeting in a seminar, discussed a paper prepared by a consultant on small tropical island countries (EBD/83/325, 12/19/83; Sup. 1, 1/26/84; and Cor. 1, 5/3/84), together with a companion paper providing a comparison with small, developing non-oil continental Fund members (EBD/84/125, 4/24/84; and Cor. 1, 5/3/84).

Mr. Legarda stated that the paper was not intended to be the last word on small tropical island countries, but was more in the nature of an introductory survey. In considering what the content of the paper should be, he had started by trying to determine the parameters of small tropical island countries. Directors might wish to comment on the criteria for smallness used in the paper and the list of those countries considered to be small tropical island countries.

He had summarized the important points on smallness and insularity made in the latest symposia on those topics, Mr. Legarda indicated. He had also checked the relevance of the premises or theory underlying policy. In Part V, he had tried to examine the economic characteristics, at one point in time, of the 17 Fund members classified as small tropical island countries; he had not attempted to make comparisons of those countries over time. His analysis was related to the whole adjustment process, rather than to specific macroeconomic policy. Those small island countries had open economies, severe factor constraints and, therefore, little room for maneuver, a fact that should be taken into account by the staff when designing adjustment programs for those countries. An official of one of the Western European central banks had stated that before adjustment measures could make much real impact, the small island economies needed to be broadened and deepened, which in most cases meant diversification away from reliance on a single foreign exchange earning activity. The regional development banks were able to provide financing and technical assistance for that purpose, so that pressure on Fund resources should be reduced.

Mr. Prowse remarked that, as the first systematic and extensive examination of the small tropical island countries by the Fund, the paper under consideration indeed should not be seen as the last word on the subject. It was particularly relevant that the Board was discussing the small tropical island countries in view of the special recognition given to them by Executive Directors during the Eighth General Review of Quotas and by the Interim Committee at its recent meetings.

Outlining the Fund's previous actions with respect to the small tropical island countries, Mr. Prowse recalled that between 1955 and 1965 the Fund had instituted a new quota policy with respect to those countries with small quotas. In 1982 the Executive Board had considered a staff paper on the problems of small-quota countries. At its September 1983 meeting, the Interim Committee had agreed that the Fund, in implementing its policy on access, should be particularly mindful of the difficult circumstances of the small-quota, low-income countries. There was scope for sympathetic treatment of the small-quota countries under the present access guidelines, which recognized the difficult economic situation of many of those countries resulting from their dependence in many cases on single export commodities, their transportation difficulties, and the limited range of policy instruments available to the authorities. It was because they were particularly vulnerable to shifts in the terms of trade and to natural disasters that those countries accounted for a high proportion of compensatory and emergency financing assistance from the Fund. He hoped that the outcome of the present meeting would determine whether the Fund was providing adequate support for those countries or whether further steps might be appropriate.

Although the economies of the small tropical island countries were open and shallow, with little secondary and tertiary forms of development, they were not necessarily fragile in the way that a small, shallow, industrial economy might be, Mr. Prowse remarked. In fact, some of the small island economies had been surprisingly flexible and resilient under strain, primarily because of the large noncash sector in their real economy. However, the existence of a large noncash sector, which often provided an important cushion, also meant that economic management was constrained in terms of the range of instruments that could be deployed, a point that should be borne in mind when Directors considered how the Fund should be treating those island economies.

While Mr. Legarda's paper was descriptive rather than empirical, Mr. Prowse observed, its considerable insights demonstrated that although there were differences among the small tropical island countries, they did share common constraints in varying degrees. Mr. Legarda had identified those constraints by analyzing the literature and deriving the various functions of their economies. Furthermore, he had examined the experience of individual small tropical island countries. He agreed with Mr. Legarda on the problems faced by those countries, relating to diseconomies of scale, a narrow product and export base, high vulnerability to shocks, and transport disadvantages.

As indicated on page 2 of EBD/84/125, the small island countries were the smallest of the small, in terms of land area, population, and GNP, Mr. Prowse noted. A report of the United Nations Conference on Trade and Development (TD/B/950) argued that a population of 1.2 million constituted the dividing line beyond which the population was sufficient to compensate for the worst constraints of insularity, which began to be evident at populations of 600,000. All the small island countries identified by Mr. Legarda, with the exception of Mauritius and Fiji, had populations of less than 600,000 and therefore could be expected to be suffering from those constraints.

It would have been useful if the paper had included a rigorous statistical analysis of how the small tropical island countries differed as a group from all others, particularly regarding the characteristics that were relevant to the adjustment process, Mr. Prowse stated. For example, with respect to openness, how did the ratio of foreign trade to gross domestic product of the small island economies as a group differ from other groups? According to his own crude analysis, the average ratio for the 17 small tropical island member countries of the Fund was 73 percent, which was much higher than the ratio of 9 percent for low-income countries as classified by the World Bank. Middle-income countries had an import/GDP ratio of 23 percent, and industrial countries had one of 20 percent. Even high-income oil exporters had a lower ratio of 69 percent. On vulnerability, were the fluctuations in foreign exchange earnings of the small tropical island countries significantly greater than for other countries? How did the external accounts of those countries behave through time compared with other groups? The ratios of concentration on particular sources of foreign exchange earnings were subject to greater fluctuations for the small island countries than for other countries. It would be interesting to see whether the sectoral composition of GDP, and the structure of demand among government, investment, consumption, and exports, differed systematically within the group of small island countries and between that group and others.

He had hoped that it would be possible to include in the paper a rigorous empirical analysis of the experience of the small tropical island countries in adjusting to severe external shocks, Mr. Prowse continued. Such an analysis would be helpful to other small island economies confronted with similar problems in the future, and would be of use to the staff in formulating adjustment programs, particularly in view of the constrained range of macroeconomic tools available to those countries. Were the small tropical islands more likely to be in external disequilibrium than other less developed countries (LDCs)? Was a flexible exchange rate policy appropriate for those economies?

The degree of financial development, which varied considerably among the small island economies, determined the effectiveness of monetary policy, and a more extensive survey and analysis of their monetary and financial systems would be particularly useful, Mr. Prowse commented. He hoped that the various issues he had raised could be subject of future research.

The Fund guidelines on conditionality already provided for considerable variation in the design of Fund-supported adjustment programs, which might take account of the particular circumstances of the small tropical island countries, Mr. Prowse remarked. He would like to see some analysis of the design of Fund-supported adjustment programs for those countries, and of their performance under the programs. He reassured Executive Directors that he was not intending to recommend any dramatic change; but he hoped that, within the broad guidelines, the Fund could provide effective adjustment programs for the particular circumstances of small tropical island countries. A further empirical study of the effectiveness of the various macroeconomic instruments in those island economies was necessary. The paper before the Executive Board was more applicable to the developing countries in general than to the tropical island economies specifically.

While carrying out further studies, including more quantitative analysis, of the policy issues and the design of adjustment programs, Mr. Prowse considered, the staff must consider fully the special constraints on the policy options facing the small tropical island countries, namely, the problems of export diversification and protectionism and the need for the adjustment process to be geared to a different time schedule. He recognized, however, that the type of problems faced by small island countries were more in the realm of the World Bank, regional banks, and bilateral aid donors. In designing adjustment programs, the staff might like to consider a suggestion of the Western Samoan authorities that the performance criteria might use "safety bands" that would take account of the difficulty of implementing macroeconomic policy precisely and the sensitivity of the economy to external factors. Furthermore, the criterion of balance of payments need should be determined with respect to the particular problems of the small island economies. Those extremely open and volatile economies would need a higher level of reserves than most other countries to sustain stable medium-term growth.

Furthermore, the Fund should increase its technical assistance to the small island countries, Mr. Prowse said. Staff reports on recent economic developments (REDs) in small tropical island countries should, if anything, be made more rather than less comprehensive. The authorities of those countries found the REDs extremely useful, and often used them as the major source of reference on their economies.

He was not clear about Mr. Legarda's suggestion for a consultative group on adjustment for the small island economies, but assumed that it would be similar to that of the aid consortium sponsored by the World Bank, Mr. Prowse remarked. Could Mr. Legarda comment further on that suggestion?

The background studies suggested by Mr. Legarda would be more appropriately carried out by the World Bank and regional development banks, Mr. Prowse considered. The small tropical island countries faced problems in raising productivity in the sectors in which skilled manpower was required. The usefulness of parastatals in such economies should also be considered. The 200-mile economic zone around island countries also had interesting economic implications. But those were not issues that should be considered by the Fund. On the contrary, the Fund should focus as precisely as possible on the design of adjustment programs and the quantification of the problems of small tropical island economies. The Fund should also determine whether it would be possible for the many multilateral and regional institutions to standardize their data requirements, a development that would reduce considerably the burden of the small island economies.

One member of his constituency had indicated that it faced chronic balance of payments difficulties, which it was unable to deal with in the most efficient way through project aid, Mr. Prowse said. In fact, that member often had difficulty identifying and maintaining appropriate projects for development aid, and had suggested that given those difficulties it would be prepared to accept ongoing advice from the Fund, without its financial support, as a precondition for "untying" multilateral project aid.

Mr. Leonard remarked that Mr. Legarda's paper provided a convenient framework for the discussion of small tropical island economies, which had a number of characteristics and problems in common that were nevertheless not peculiar to such countries. The real matters at issue were the nature of the difficulties arising from certain economic characteristics of countries and the appropriate response to them. Smallness was the leading factor with which the present discussion was concerned. Mr. Legarda had examined what smallness implied in terms of labor force, capital stock, and natural resources. The economic characteristics associated with smallness included limited economies of scale, low output volume, confinement of production to a few major commodities, and limited domestic markets. Other factors to be considered were geographical and functional remoteness, insularity, liability to natural disasters, and fiscal and financial dependence. His experience of countries with combinations of those characteristics mainly related to island economies in the Caribbean.

From the Fund's viewpoint, he was interested in the answer to four questions, Mr. Leonard commented. Were there factors at work that tended to push the small tropical island countries toward external imbalance? Under what conditions could those countries be expected to achieve reasonable external stability? How could those conditions be met? What were the implications for the Fund's policies and activities?

There were clearly factors at work that tended to push those countries toward external imbalance, Mr. Leonard considered. The small tropical island economies were price takers, and were particularly susceptible to the vagaries of world trade, problems that were exacerbated by their limited range of tradable goods. Furthermore, their exports could be blocked by protectionism and affected by natural disasters. Owing to the growth of the tourism industry in many of those countries, they were subject to the demonstration effect of the consumption patterns and higher standards of living of advanced societies. The ability of the island countries to pay for rising imports was limited, and was likely to be upset at any time by factors outside the authorities' control. A pronounced tendency toward external imbalance existed, and demanded the attention of the Fund.

The conditions under which the small island economies could be expected to reach reasonable external stability could not be determined in simple balance of payments terms, Mr. Leonard went on. External stability involved the country's capacity for economic development. Mr. Legarda had examined the possibilities for and the limitations on the diversification of production, the role of multinationals in manufacturing, and the specific opportunities offered by tourism, offshore banking, and fishing in the tropical islands. In other small economies, the specific opportunities would probably be different, but their exploitation in all cases would have the same objective of increasing export earnings to pay for the higher imports that were an inevitable feature of rising living standards.

Many demanding conditions had to be met in the successful pursuit of development, and the benefits to the small economy were hard won, Mr. Leonard remarked. Progress would often depend on a happy coincidence of a technical or marketing innovation, a change in consumer tastes, or the emergence of a local source of enterprise. In the face of those difficulties, it was hard to avoid the conclusion that movement toward external equilibrium through the normal development process must continue to be slow and subject to interruption. It was not surprising that in many small economies the level of imports required to sustain modest living standards and investment levels could be afforded only as a result of extensive donor grants and concessional loans, without which output and living standards would have to fall and the outlook for the countries concerned would be bleak.

As to his third question, Mr. Leonard continued, reasonable external stability would be brought about through intensification and improvement of the adjustment efforts already being applied. Efforts to stimulate growth must be strengthened, and special aid must be provided to bridge the gap between exports and the level of imports necessary to support improved economic well-being.

The paper cited the contrast in economic development between certain independent islands in the Pacific and Caribbean and those given metropolitan status as a department of a larger country, Mr. Leonard observed. Leaving aside the considerable political issues involved, the economic model provided by the departmentalized islands deserved closer study.

He was in support of the argument put forward in the paper in favor of a multilateral approach to economic development in the small tropical island countries involving the World Bank, the regional development banks, and donor countries, Mr. Leonard said. What was the Fund's role in that approach? The fact that a number of the normal macroeconomic policy instruments lost their relevance in small economies, owing to the protectionist measures and other economic obstacles to world trade, did not give the Fund a mandate to take a leading role in countering protectionism or promoting development. Nevertheless, there was a pronounced tendency toward chronic external imbalance in the economies being discussed, and that tendency was a concern of the Fund. Were the instruments available to the Fund adequate to correct that tendency? If so, what changes in their use would help to give more satisfactory results in those countries than at present seemed likely? If, on the other hand, the means of the Fund were not equal to the task, how could they be supplemented? Those issues should be examined more closely by the Fund and the further thinking on them put before the Executive Board for consideration. Finally, he agreed with almost all the points made by Mr. Prowse.

Mr. Moerke stated that he would, first, touch briefly on the question of whether or not small island countries had special economic characteristics and economic problems. Second, he would comment on Part VI of the paper in which Mr. Legarda suggested possible Fund action regarding the small island countries. He would indicate at the outset that his authorities supported only a limited number of the suggestions put forward in the paper.

The merit of Parts I-V of the paper lay in the summaries of previous articles dealing with the special economic characteristics and particular economic problems of small island countries, Mr. Moerke considered. The long list of references was impressive. However, he had problems reconciling the different arguments, perhaps because of the quotations from numerous sources, both within and outside the Fund. In the fourth paragraph of Part VI, it was suggested that characteristics and problems typical of the small tropical island countries could be identified, an observation that was difficult to reconcile with various arguments presented in other parts of the paper explaining the diversity of those countries. He found it difficult to detect any special characteristics and problems that were typical of only small island economies. Nevertheless, there were countries within the group that faced particular difficulties as to their nature as well as to their degree of intensity. However, the need to cope with special economic problems was typical not only of small island economies; many other countries also faced special problems, such as the landlocked countries, the least developed countries, the sub-Saharan African countries, the small industrial countries that were highly integrated in common markets, or the Central American countries. It could also be argued that most of the countries in South America had particular difficulties owing to the regionalization of commercial bank attitudes.

The special problems of some of the small tropical island member countries did not justify any preferential treatment by the Fund, Mr. Moerke considered. His authorities did not favor many of the proposals included in EBD/83/325. They were particularly opposed to the proposals in Part VI, Section B on adjustment and related problems. Other suggestions in Part VI, Sections C, D, E, F, and G of the paper might deserve further consideration.

His authorities were concerned that special treatment for a group of countries that was rather diverse could have detrimental consequences for the Fund, Mr. Moerke indicated. The principle of uniform treatment of members would be violated, and the very nature of the Fund's policy would be changed. How could requests from other countries with their own special problems be rejected once small island economies had been granted special treatment? Such preferential treatment would unavoidably encourage other groups of countries to demand their proper share of special treatment. Although that might sound somewhat exaggerated, there were references in the paper indicating that preferential treatment for small island economies might be only the start.

His authorities found it difficult to accept the notion conveyed in the paper that the Fund was well equipped and qualified to cure most economic problems regardless of their nature, Mr. Moerke went on. The concept of adjustment on which Part V was based did not take sufficiently into consideration the specific nature of the Fund as a monetary institution. The focus of the Fund was on effective adjustment to deal with temporary balance of payments problems. A viable balance of payments position should be achieved in a relatively short period of time. Mr. Legarda had stated on page 45 that "the essential point to bear in mind is that adjustment for small tropical island countries is a longer-term process with developmental dimensions." If that view were accepted, it could be concluded that adjustment had to be supported by typical developmental instruments, like bilateral and multilateral development aid. Other institutions were better equipped than the Fund to deal with that kind of adjustment.

Small island member countries should certainly have the benefit of Fund assistance if those countries faced external and internal imbalances that the Fund was equipped to deal with, Mr. Moerke remarked. As Mr. Legarda himself had indicated, the Fund had assisted them in many ways, both quantitatively and qualitatively. In formulating adjustment programs, the Fund should pay due regard to the special characteristics and problems of member countries. The guidelines on conditionality and the possibility that existed of providing emergency assistance gave the Fund enough scope to react flexibly to individual problems of member countries.

The more specific proposals put forward by Mr. Legarda--for adjusting small quotas, establishing a special facility financed from certain SDR allocations, a counterprotectionist facility, introducing longer-term adjustment programs, and studying the merits of a natural disaster facility--were steps in the wrong direction, Mr. Moerke considered. They would violate the principle of uniformity of treatment, would constitute development aid, or would compromise the purpose of the SDR. His sharp criticism was not meant to diminish in any way the merits of the study; it only reflected different views about important aspects of Fund policy.

Finally, he agreed with the suggestions in Sections C, D, and E of Part VI to improve Article IV consultations, the design of adjustment programs, and staff reports on recent economic developments, and also to upgrade economic statistics, Mr. Moerke remarked. Those suggestions deserved further consideration by the staff. The background studies mentioned in the paper also had some merit. But caution was warranted as most of them dealt with issues that might fall within the expertise of the World Bank.

Mr. Hirao observed that the paper dealt with a variety of issues that the small tropical island countries faced in framing their development strategies. The economies of those countries could be described as small, open, dependent, and unstable, characteristics that, although conceptually distinct, were interrelated, and that might pose some specific and somewhat different economic problems from those of the larger countries. In particular, the small island countries could not benefit fully from economies of scale, and their economies were unstable as a result of heavy dependence on the export of a few primary commodities subject to wide fluctuation. It could be argued that those were common problems confronting many developing countries; however, it might also be true that they became even more conspicuous and difficult in small island countries with severe factor constraints in terms of labor and capital markets. In determining their development strategy, those countries were faced with a dilemma; on the one hand there was a need for economic diversification in order to alleviate instability, and on the other hand, there were severe factor constraints that limited the scope for diversification.

The paper indicated that in countries with a small population there was considerable pressure on the public sector to provide a wide range of services, leading to a shortage of trained manpower in the private sector, Mr. Hirao went on. In view of that constraint, an appropriate development strategy should aim at gradually diversifying the economy, with greater emphasis on some sectors--for example, tourism or production of nuts and fruits--in which economies of scale could be realized. He could broadly endorse Mr. Legarda's suggestion on diversification.

However, small tropical island countries' access to export markets varied considerably, Mr. Hirao noted. Therefore, each country would have to develop its own method of diversification. For example, not all those countries could promote fisheries as an export industry, given the resources needed for a minimum level of viable operations. Some islands, with favorable soil and climatic conditions, were self-sufficient in agricultural products. That self-sufficiency provided a certain degree of resilience in the economy, and the issue was how to progress beyond it while retaining an acceptable degree of self-reliance.

On macroeconomic policy, the maintenance of a stable real exchange rate seemed to be particularly important for small open economies, Mr. Hirao stated. In that respect, the proposal in EBD/83/325 to include weights for tourism in the analysis of the effective exchange rate was worth considering.

The question raised in the paper regarding the reliability of GNP per capita as an indicator of a standard of living was interesting, Mr. Hirao noted. The paper indicated that economies with a relatively large tourism sector seemed to have higher per capita incomes, and that associated or dependent small tropical island territories also had higher per capita incomes on average. Further consideration on those points might be useful.

Transportation facilities had been deteriorating in the remote tropical island countries, Mr. Hirao remarked. Further analysis needed to be carried out on the possible implications of rising transportation costs, including the effect on exchange rate policy.

Finally, the upgrading of statistics in those economies was a matter of importance, Mr. Hirao considered. Perhaps the Fund could play a significant role in that upgrading. Efforts should also be made to examine the divergence between the statistical requirements of the Bank and those of the Fund.

Mr. Clark noted the diversity of the small tropical island countries that were Fund members. Per capita income varied by a factor of 12, land area by a factor of almost 100; population ranged from about 1 million to less than that of a country town. Geographical locations were just as varied, some islands being within a few miles of a major land mass, while others were thousands of miles distant. As the paper noted, there was no typical profile for a developing island country. But there were certainly many similarities, including openness, an orientation toward invisible trade, tourism, a narrow economic base, and, with the notable exception of the Solomon Islands, dependence of trade on a few exports.

With respect to whether the small tropical island countries had special problems, Mr. Clark noted that their economic situation clearly reflected both their size and isolation. Among the more important problems were vulnerability to weather, high domestic and external transport costs, and little scope for economic diversification and expansion owing to limited access to economies of scale and capital markets, and a shortage of skilled manpower. The paper clearly stated the effects of those factors on both economic management and future prospects. Although few of those problems were unique to small tropical island countries--many were also characteristic of, say, sub-Saharan countries--the small island countries did suffer to an unusually high degree from those problems.

As to whether small tropical islands needed special treatment by the Fund, Mr. Clark remarked that there was an argument, put forward in the paper, which suggested that they might actually need less support than others. Their openness forced rapid adjustment to external shocks, so that structural imbalances were not allowed to build up. Indeed, a number of the small island countries under study were in a relatively good position, especially compared with many other developing countries, and had a relatively high per capita GDP. But that was not the whole story. Small islands' extreme vulnerability to external shocks meant that conventional adjustment policies often failed to achieve the expected results. Adjustment was closely tied to development, in particular to the problem of diversification. However, it was difficult to make a convincing case for special treatment on those grounds. The diversity of the small tropical island countries suggested that no general prescription would be appropriate. The Fund should maintain the principle of uniform treatment of members, and its existing facilities seemed sufficiently flexible to meet their needs.

There were a number of areas in which the Fund and other institutions could help the small tropical island countries, Mr. Clark stated. First, with respect to development, the need for diversification was perhaps the critical problem and was not a matter principally for the Fund. The practical possibilities were limited, although tourism and fishing appeared to be the most promising sectors for development. Despite the difficulties, Maldives and Solomon Islands had achieved some success in diversifying their economies, and he would have welcomed further discussion in the paper on the reasons for their success. A number of development and infrastructure problems might, as had been stressed by the Asian Development Bank, be alleviated through increased cooperation with neighboring countries. Although the paper touched on that issue, he would have welcomed further discussion on the extent to which cooperation had already occurred and possible action for expanding it in the future. That matter could be a fruitful area for further research, principally by the regional development banks and the World Bank. Most small tropical islands remained dependent on concessional aid; there was therefore a need for cooperation among multilateral banks, donors, regional banks, and the islands themselves.

Second, on technical assistance, the lack of skilled management and expertise in many small islands could seriously hamper development, Mr. Clark noted. Although 17 of the small tropical island member countries had made use of technical assistance by the Fund, there might be scope for expanding such assistance, in connection with the World Bank and regional banks, to cover other than traditional areas.

Third, on financial support, the existing Fund facilities were sufficiently flexible to cover most eventualities, Mr. Clark considered. He favored one-year stand-by arrangements with a structural content, although longer-term programs should not be ruled out. In particular, the compensatory financing facility seemed most appropriate to meet the needs of the small tropical island countries; the vulnerability of those countries to natural disasters, particularly cyclones and hurricanes, made the Fund's emergency assistance particularly valuable.

In general, as development was more often needed than adjustment, the Fund's role in helping the small island countries was fairly limited, Mr. Clark said. Once short-term adjustment had been achieved, follow-on diversification efforts, which were more in the province of the World Bank, should take priority. However, shadow Fund programs could be useful in reassuring creditors and in providing a framework for World Bank structural adjustment loans. Finally, it would have been useful if the paper had drawn some more general conclusions, for example, with respect to the tradeoff between diversification and economies of scale. Conversely, perhaps there should have been less discussion of the parameters defining the small island countries. The best response to the problems of those countries was to continue providing Fund support through existing facilities, and to strengthen collaboration with other organizations, particularly the regional development banks.

Mr. Kafka remarked that he had learned a great deal from Mr. Legarda's papers. The statistical tables in EBD/84/125 indicated that it was appropriate to address the small island countries as a separate group. With few exceptions, the small island countries were small in terms of area, population, and GNP. They had a higher population density and import/export ratio than the smallest continental countries. The Fund had been active in all the small tropical island countries, although an exceptionally high share of resources had been directed to one island.

Some of the problems affecting small island countries had been accurately summarized by Mr. Legarda, Mr. Kafka went on. Protectionism had a particularly damaging impact on their open economies, which were often very specialized. Mr. Legarda had recognized the Fund's concern about protectionism, but he had stressed that even more must be done. Unfortunately, the Fund had no leverage over countries that did not require assistance, and it was those countries that constituted the largest markets for the small tropical island countries. It was particularly difficult for small countries with a narrow resource base, whether islands or not, to adjust quickly in the face of external shocks other than by allowing their GNP to fall dramatically, an unsatisfactory form of adjustment. A combination of Fund and developmental assistance from various sources was essential. That the incidence of natural disasters was likely to be higher and more frequent in small islands might give rise to consideration of the establishment of a special disaster facility in the Fund, other than under the compensatory financing facility. In its consultations with small island members, the staff should examine the impact that transportation subsidies elsewhere might have on those countries.

It was particularly relevant to attempt to identify as early as possible any changes in the small island countries' terms of trade, Mr. Kafka considered. Whether those changes were more of a cyclical than a long-term nature should be determined in order to help the staff and the authorities to formulate appropriate adjustment policies.

Additional examination of the topics discussed in the paper was justified, Mr. Kafka continued. Any follow-up studies, however, should not be only analytical. The Fund must examine, in line with the recent suggestions of the Interim Committee, its policies and facilities as they affected small countries, particularly tropical island countries. No derogation of the principle of equality of treatment was involved if the Fund responded to the particularly acute needs of those countries. Since the solutions were largely developmental, the Fund must not act alone, but must encourage the involvement of the regional development banks and other institutions. In that respect, he could support the suggestions put forward by Mr. Prowse and Mr. Leonard.

Mr. Jaafar stated that one of the major impediments to the economic development of small tropical island countries, particularly in the South Pacific, was the cumbersome and complex land tenure system, which had been a major obstacle to investment in agriculture. Much of the land was communally held and used for subsistence agriculture; in some countries, the leasing of land to farmers was mainly on a short-term basis and subject to much uncertainty. The land tenure system was embodied in the cultural tradition of local society and was therefore difficult to change; but change it must to make room for greater investment in land development and agriculture.

Another problem was related to the high cost of transportation, Mr. Jaafar observed. In many areas, a collective approach to the transportation problem was needed. Given the small size of the communities involved and the large distance between islands, it might be unrealistic to have a commercially viable transportation system. However, transportation facilities were essential for the development of a region. In some island groups in the South Pacific, for example, such facilities had been provided by the authorities at great expense. The lack of international transportation facilities had also led to the creation of a regional shipping line, which operated well below capacity. Most of the operations were subsidized by the large countries of the region, including Australia and New Zealand. Without assistance and a collective approach, some of those small island countries would be totally isolated. In such special cases, subsidies and assistance should be seen as essential and should be accepted by the international community with understanding.

Diversification of small island economies was difficult, given the size of their markets and lack of resources, Mr. Jaafar continued. Yet the authorities had made economic diversification an important objective in order to insulate their economies from the wide fluctuations that were acutely felt by the tropical islands. In pursuit of that objective, incentives had been introduced that had been generally unsuccessful. In his view, a better strategy might be to aim at a more limited scale of diversification. Small island countries could achieve economies of scale only if they concentrated their resources in the production for exports of a few items in which they had a comparative advantage. In order for that strategy to be successful, it was essential for them to have access to markets, particularly those of industrial countries.

The high per capita income of small tropical island countries could be explained to some extent by the large volume of their exports to member countries of the European Community, under the Lomé Convention, Mr. Jaafar observed. Such trading arrangements should be encouraged, as they could substantially improve the development prospects of island economies.

The paper correctly identified the great potential for fisheries in small tropical island countries, Mr. Jaafar noted. Some of those countries did have fishing industries, but the local participation, and therefore the domestic value added, in such industries was minimal. Canning, freezing, transportation, and even fishing were often controlled by foreign companies using foreign resources, including labor. The only exception was in Maldives, where local participation in the fishing industry was predominant. Nevertheless, the fishing industry had tremendous potential, which should be developed.

Tourism also had its potential, but the import content was high and required a great deal of infrastructure, Mr. Jaafar stated. Many of the islands had appropriate natural resources, but were concerned with preserving the local culture.

One of the major difficulties facing small island economies was the lack of people with technical skills to identify and prepare projects for foreign financing, Mr. Jaafar continued. Unlike the larger developing countries, small island countries often had to rely on foreign assistance for project preparation. As a result, many of those countries were unable to make full use of the assistance available from multilateral development agencies. Perhaps the World Bank could provide technical assistance to help the authorities identify and evaluate projects and upgrade the training of local personnel.

One characteristic of governments in small tropical island countries was a large and growing public sector, Mr. Jaafar observed. Many of those countries had the same number of ministries as the large industrial countries, and provided extensive social services and foreign diplomatic representation. Furthermore, many of their parastatal organizations had met with more failures than successes. Thus, attention would have to be paid to improving the efficiency of the public sector and reducing the size of government.

One question often raised was whether fiscal policy could be used as an instrument of countercyclical policy in small island economies, Mr. Jaafar went on. In his view, countercyclical fiscal policy in those economies was effective in only one direction, namely, to reduce demand in the event of excessive liquidity; it could not be used to increase demand when there was a shortage of liquidity arising from an external deficit. A similar limitation also applied to monetary policy, which could not be used to stimulate demand when the external sector was weak. Because of the inability of those countries to use countercyclical policies in times of recession, a case could be made for stabilizing export commodity prices and for providing external assistance by the Fund and other multilateral agencies.

A rapid rate of monetization of the island economies had taken place in the past decade, Mr. Jaafar observed. In many of those countries, the subsistence sector currently accounted for less than 10 percent of total production. There was almost complete access by the rural population to banking facilities. In addition, per capita income in many of the island countries was high. All those factors suggested that interest rate policy should be used to mobilize savings and to channel resources to productive sectors of the economy. He encouraged those countries to maintain a positive rate of interest in real terms.

On exchange rates, he agreed that linking the local currency to a trade-weighted basket of currencies gave stability to the exchange rate, Mr. Jaafar said. But that did not mean that the rates were equilibrium rates: many island countries maintained an overvalued exchange rate, and some pursued a policy of appreciating the exchange rate in order to control inflation. Such a policy was not appropriate when the objective was to strengthen the export sector; it should be reserved primarily for achieving external equilibrium. As the small island economies were price takers, the impact of an exchange rate change was limited to export incentives and income distribution, and it was those elements that should be examined closely by the staff during Article IV consultations.

On the role of the Fund with respect to the small island economies, Mr. Jaafar said that since they had limited or no access to world capital markets and were particularly vulnerable to external developments, owing to their reliance on a few products, consideration should be given to providing special assistance to mitigate their difficulties. He recognized, however, that other countries--the landlocked, the sub-Saharan African, and least developed countries--also faced particular difficulties.

Management and staff should take into account the problems of small island economies when determining the level of access to Fund resources and the associated conditionality, Mr. Jaafar stated. The compensatory financing facility was particularly useful to the island economies, owing to their dependence on a few primary exports; resources under that facility should be granted expeditiously and with few conditions. Small island countries also faced frequent natural disasters, and the Fund should provide emergency assistance more frequently than it had thus far. Fund technical assistance for improving statistics and economic management had been extremely useful to those countries and should continue to be given. Furthermore, Article IV consultations had proved to be a valuable exercise; in some island countries, they were the only occasion when statistics from all sectors were compiled and analyzed, and when forecasts were made. Article IV consultations with small tropical island member countries should thus be held on a 12-month cycle. A more important role could be played by the World Bank in project preparation and implementation.

On more specific points, he agreed with Mr. Legarda that GDP was a misleading indicator of development and welfare in the island economies, Mr. Jaafar said. Too much weight should not be placed on that indicator in determining eligibility for external assistance.

He noted the argument put foward on page 8 of EBD/83/325 relating to the establishment of a full-fledged central bank to develop financial intermediaries, Mr. Jaafar stated. The staff of the Central Banking Department had used that argument in making a case for the establishment of a reserve bank in one particular country to take over from a monetary authority that had been in existence for ten years. In the country in question, the monetary authority already had the necessary legal power to promote financial institutions; in fact, it had had greater autonomy on monetary and exchange rate matters before the establishment of its successor, the reserve bank. Therefore, he could not agree with the staff's general suggestion that it was necessary to have a full-fledged central bank to establish financial intermediaries. A monetary authority could usually do the job just as well in small economies.

The observation in the paper that, for small economies, the real financial constraint related to the deployment of funds rather than to the mobilization of funds was derived from a Central Banking Department report on financial institutions in a particular island economy, Mr. Jaafar observed. It was his understanding that in the economy concerned there had been a temporary reduction in the demand for loans, owing partly to economic factors and partly to political uncertainties at the time. Those problems had disappeared, and the authorities were currently faced with a problem of excess demand for credit. The Fund should exercise caution when considering the position of a country at a particular point in time, as the characteristics of that position might not be true generally.

Finally, the small island economies ought to receive special treatment by the Fund and other multilateral organizations, Mr. Jaafar considered. However, some small landlocked countries such as Bhutan and Lao People's Democratic Republic suffered from no less disadvantage than those small island economies, and they should therefore have special consideration extended to them.

Mr. Tvedt stated that he agreed that the small tropical island countries faced some unique problems, stemming from their smallness and geographic isolation. An important question that emerged from Mr. Legarda's papers, although it was not addressed in them, was the minimum size of an economy that could enjoy relative stability and support an efficient infrastructure. Whatever the minimum, many of the countries included in the study clearly fell below it. Where islands were clustered together, it seemed appropriate for them to increase their economic and political cooperation. Some steps had been taken, in particular, toward monetary cooperation in the Eastern Caribbean.

The Fund was not equipped nor was it the appropriate institution to deal with many of the problems facing the small island countries, Mr. Tvedt considered. Other institutions such as the World Bank and the regional development banks could better assist them. Nevertheless, the Fund should continue to provide technical assistance, especially to help the authorities to improve their administrative capabilities. Article IV consultations were an important form of technical assistance.

As the small island economies were generally dependent on a few export commodities and were subject to wide fluctuations in export receipts, the compensatory financing facility was essential to them, Mr. Tvedt went on. The resources available under that facility were a means of temporary balance of payments support and should not be used for rebuilding efforts after natural disasters, as suggested on page 45 of the paper; other institutions must provide aid for that purpose. The Fund could provide emergency assistance after a natural disaster, and some of the small island countries had received such assistance. In general, however, the Fund should not single out that group of countries for special treatment. He would be willing to consider, on a case-by-case basis, a somewhat liberal application of working guidelines for the amount of Fund support for adjustment programs in those countries with the smallest quotas.

In sum, while much could be done to improve the Fund's knowledge of the small island economies, their viability and prospects, some of the studies suggested in the paper clearly lay outside the Fund's sphere of expertise, Mr. Tvedt said. He found it difficult to support the recommendation that they should be undertaken by Fund staff.

Mr. Doe welcomed the opportunity to discuss the small tropical island countries, as 4 of the 17 countries under consideration were in his constituency. He agreed that in some respects the problems facing the small island economies were similar to those faced by many less developed countries. However, the combination of circumstances--such as factor constraints, a narrow domestic market, and geographical isolation--underscored the limited room for maneuver and the difficulty of implementing policies aimed at establishing a stable noninflationary economic growth.

He agreed with Mr. Prowse that the task of identifying the characteristics and problems specific to small tropical island countries was difficult, Mr. Doe went on. Their insularity placed strong limitations on the ability of many of the 17 small island countries to implement an integrated economic development policy. As Mr. Legarda had indicated, it would be impractical for many of them to share infrastructure, such as transportation, electricity, and water facilities, something that could be done easily in two small landlocked countries adjoining each other. The cost of supplying those services was all the more prohibitive given the archipelagic nature of some of those countries. They could not therefore reap the benefits of economies of scale associated with multinational integrated projects.

The occurrence of unpredictable natural disasters, such as hurricanes, had destructive consequences on small island economies, Mr. Doe remarked. The extreme vulnerability of many of those economies deserved special attention, and in that context he shared many of the views expressed by Mr. Legarda on page 45 of EBD/83/325 regarding the need for a fund to finance recovery from natural disasters.

Small tropical island economies would benefit greatly from diversifying their agricultural production, Mr. Doe remarked. Citing Mauritius as a country where diversification efforts had been appropriately directed, the author had suggested that the industrial and tourism sectors were appropriate for diversification. The Mauritian authorities were attempting to create a broad-based economic structure both intersectorally and intrasectorally. They were also taking further steps to diversify agricultural production.

Small tropical island economies did face special constraints, including impediments to economic integration owing to their insularity, Mr. Doe commented. He agreed with Mr. Prowse that a further study should be undertaken to provide more details about the problems of small tropical island countries. Such a study could help the Fund to provide more effective assistance to the countries concerned, and would clearly be in line with the recommendation of the Interim Committee that the Fund should be particularly mindful of the special needs of the small-quota countries.

Mr. Camara stated that although Mr. Legarda's paper focused on small tropical island countries, many of the problems identified in the paper were also characteristic of other developing countries, particularly in Africa. Therefore, the suggestion that those problems required special treatment was relevant not only to the small island economies but also to all countries facing a similar fate. Smallness, as defined in the study, and the geographical constraints arising from the insularity of those countries, were sufficient but not necessary conditions for experiencing the problems identified in the study.

Like the countries in the study, most African countries had open economies with a high degree of commodity and market concentration, making them extremely vulnerable to developments in export markets and to policies of their main trading partners, Mr. Camara went on. Price instability and low elasticity for primary commodities in major markets had adversely affected growth prospects of the tropical island economies largely because their terms of trade had deteriorated, making it difficult for them to maintain imports at a rate consistent with their objectives. Small island countries and some other countries with a high degree of dependence on foreign markets had difficulty in adjusting to changing conditions in the world economy. Many of the constraints of small island economies were operative in low-income developing countries, particularly a lack of skilled labor and scarcity of resources. It followed that those countries were also faced with the same limitations regarding the use of macroeconomic policies, be it to counter the impact of exogenous factors or to promote adjustment within their economies. The lack of basic financial infrastructure, the fragmented nature of their markets, and the inflexible nature of revenues made the exchange rate, fiscal, and monetary policies less effective.

The existence of the particular problems outlined in the paper justified special treatment for the small island economies, Mr. Camara continued. In designing adjustment programs, the Fund should take special account of those difficulties. The Fund could play a crucial role in promoting adjustment by redesigning adjustment programs, strengthening its surveillance over trade policy, with particular emphasis on removing trade barriers, and promoting more stable exchange rates.

Given the limited ability of low-income countries, including small island economies, to adjust quickly, and the limitation of macroeconomic policies in those economies, there was a need to give higher priority to policies that would increase output and promote diversification in order to improve trade, strengthen financial infrastructure, and secure adequate financing on concessional terms, Mr. Camara went on. Closer cooperation among donor countries and international commercial banks was essential.

He fully supported Mr. Legarda's suggestions on page 44 of EBD/83/325 with respect to adjustment financing, increasing access of small island countries by adjusting small quotas, and the use of SDR allocations accruing to developed countries for financing adjustment programs, Mr. Camara remarked. A similar paper by the staff on the characteristics and special problems of low-income developing countries in general would help the Executive Board to see the similarity of the problems experienced by small tropical island economies and other developing economies. Finally, he could endorse a number of the suggestions put forward by Mr. Prowse.

Mr. Ainley said that he would base his remarks on the three main questions posed by Mr. Legarda on page 1 of EBD/83/325. First, the small tropical island countries did have special characteristics and problems. It was always difficult to isolate one group of Fund members and to establish whether those members were better or worse off than others. But on the evidence presented by Mr. Legarda, it appeared that the countries under study did have common characteristics and did face particular problems not encountered by other Fund members, at least not to the same degree.

The small island countries had limited resources and experienced diseconomies of scale, Mr. Ainley went on. They were dependent on prices set in world markets and, because of their insularity, were isolated by inadequate transportation facilities and poor communications. They were also more vulnerable than most other members to external shocks and natural disasters. That combination of problems set them apart, to some extent, from other Fund members.

With respect to devising special programs for those countries, Mr. Ainley continued, the problems that they faced were essentially development problems. The tropical island countries could overcome the disadvantages of diseconomies of scale and geographical isolation only by implementing clear long-term development plans. Ideally, the authorities of small island countries in a particular region should meet with the World Bank, regional development banks, traditional donors, and the larger neighboring countries to develop a long-term strategy for the region. The aim of such a collective approach would be to expand the productive base and increase the absorptive capacity of the region by identifying and planning infrastructural improvements, expanding communications between the islands, and identifying viable projects in areas of comparative advantage. Other regional initiatives, such as regional common markets and financial markets, could also be examined within that framework. He was not sure whether such a collective approach would be realistic in all cases, but it was worth exploring. The Gulf Corporation Council, for example, had made important progress in developing financial and trading links between countries in the Gulf region. If a collective approach could be initiated, the small tropical islands would be better placed to use and attract concessional flows and private investment, and thus to overcome their present disadvantages. It would also provide a framework that would help the Fund in its dealings with those countries.

The technical assistance provided by the Fund to the small island countries was valued and should be intensified, Mr. Ainley considered. The recommendations of Mr. Legarda for improving, standardizing, and upgrading statistics were also appropriate. Additionally, the Fund had a responsibility to help the small tropical island countries formulate appropriate policies; it was often the only source of outside advice for some of them, and its advice was therefore listened to closely. He could appreciate that those countries wished to be kept on a 12-month consultation cycle. If they were currently on a two-year cycle, perhaps the Fund staff could hold informal discussions with the authorities every 12 months.

More specifically, the Fund had to take into account the constraints that those countries faced and the narrow range of policy options available to them, Mr. Ainley continued. The Fund could also help them to broaden their options, for example, by advising on the most appropriate exchange rate regime, the kind of basket to which a small tropical island could peg its currency, or the ways in which they could broaden the tax base and develop domestic financial markets.

More generally, the Fund had to recognize the impact of other countries' policies on the small tropical islands, Mr. Ainley remarked. The Fund should maintain its strong stand against protectionism; free trade was essential to ensure the success of any diversification efforts in the small tropical island countries. The Fund should also take into account the particular problems of the small island countries when considering their requests for financial assistance. He was not implying that they should be given special treatment, but the Fund could, for example, place special emphasis on supply-side policies, an approach fully in line with the guidelines on conditionality. Adjustment in the tropical island countries was a long-term process, and in some cases an extended arrangement might be more suitable than a traditional short-term stand-by arrangement.

The World Bank could play an important role by underpinning Fund-supported adjustment programs, Mr. Ainley commented. In that respect, he fully agreed with the Chairman's remarks to the UN Administrative Committee on Coordination in which he had said: "My belief is that Fund programs should be supported in specific ways, and with sufficient resources by the development agencies, so that countries subjected to Fund adjustment and discipline may at the same time be certain that they are working for growth and for the future. To achieve this, coordination must be extensive."

The compensatory financing facility was well suited to the needs of small tropical island economies, Mr. Ainley considered. While he favored the establishment of a natural disaster fund within the compensatory financing facility, he recognized that it was not supported by the majority of the membership. He hoped that the Fund would continue to apply its policies flexibly when small island countries experienced natural disasters. Finally, Mr. Legarda had suggested a number of interesting ideas for further study; he himself had been particularly interested in a study of the role of parastatals in small island economies. He agreed with the comments made by Mr. Prowse and Mr. Leonard regarding future studies.

Mr. Teijeiro agreed that small tropical islands did share some special characteristics. The intensity with which external disturbances were transmitted to those economies was probably greater than in others, not only because of a higher dependence on the external sector, but also because of the lack of diversification in their productive base. Those difficulties might be compounded in many cases by specific characteristics such as remoteness and transportation difficulties. However, the question remained whether the particular vulnerability of those countries justified a different approach to their economic problems. Most of those problems were structural, with long-term developmental dimensions that normally required concessional financing and participation of donor countries.

Even when some diversification was feasible, economic development went beyond the scope of Fund-supported adjustment programs, Mr. Teijeiro continued. The adjustment required in those countries was more in the realm of the World Bank and other development banks. He was not implying that the Fund had no role to play. On the contrary, the Fund could help to clear the way for an international macroeconomic policy and, working with the GATT, should encourage the reduction and eventual elimination of trade restrictions. For small tropical island countries, in which the external sector represented 50 percent of GDP, such developments would substantially improve their stability and ability to respond to external shocks.

As for the justification for special treatment of the small island countries, given the specific purposes and objectives of the Fund, Mr. Teijeiro said that those countries were more vulnerable to external developments and had less access to international financial markets. Consequently the authorities should pursue countercyclical policies, mainly through fiscal policy, and by accumulating foreign reserves during boom periods and running down reserves when faced with external shocks. Prudent management of both internal and external policies would ensure a more stable and sustainable path of adjustment; the Fund's advice and assistance played an important role in formulating and implementing such countercyclical policies. However, the limitations on the use of macroeconomic policy instruments in island economies should be taken into account.

Given the level of access of those countries to Fund resources, Mr. Teijeiro concluded, it was the view of his authorities that full use should be made of the flexibility existing under the policy on access to the Fund's resources to deal with special circumstances arising as a result of a combination of particularly damaging external shocks and limited access to capital markets.

Mr. Portas remarked that small tropical island economies had characteristics that made them vulnerable to the cyclical fluctuations of the international economy and that complicated the management of their economies. Openness, acute factor constraints, diseconomies of scale, limited domestic markets, and unfavorable geographic locations seriously affected the economic growth of those countries. However, it should be recognized that some, if not most, of those characteristics were shared by other small developing countries in varying degrees. In that respect, he agreed with the statements of Mr. Leonard and Mr. Kafka. Their size and their lack of diversification were the main characteristics imposing serious limitations on the way in which the small island economies reacted to external shocks.

He agreed fully with Mr. Legarda that the limitations facing those economies narrowed the scope of the adjustment policies that could be followed, a fact that should be taken into account in the formulation and implementation of Fund programs, Mr. Portas considered. Owing to the limitations, the measures typically introduced to bring about balance of payments adjustment were not as effective in small island countries. He could also support Mr. Legarda's recommendations to improve the content of the staff reports on recent economic developments, to give greater attention in consultations to some of the specific problems facing the tropical island countries, and to strengthen efforts in the statistical area. Finally, he supported further consideration of special assistance by the Fund to help those countries to recover from natural disasters.

Mr. Gomel stated that there was considerable ambiguity surrounding the concept of a small island economy, particularly regarding the definition of smallness. The choice was either to resort to an arbitrary cutoff point, or to be content with a looser qualitative analysis of important characteristics related to size, rather than a rigorous definition. He agreed that it was difficult to identify particular problems related to insularity and to distinguish in a clear-cut fashion between the problems of small island economies and small nonisland economies. Many groups of countries--such as the landlocked and the low-income--also faced specific problems.

He was not in favor of granting special treatment to the small island economies, Mr. Gomel went on. If such preferential treatment were approved, it would encourage other groups of countries to request similar treatment, something that would not be consistent with the Fund's principle of uniform treatment of members. The Fund was well equipped to deal with requests for balance of payments assistance. The policy on conditionality was sufficiently flexible to permit the formulation of adjustment programs that were geared to the specific needs of the countries concerned. He would welcome further elaboration by Mr. Legarda on the Fund's experience in tailoring adjustment programs to the needs of individual countries.

With respect to the proposals made in Part VI, Mr. Gomel indicated his agreement with the need to upgrade statistics and undertake further policy analysis in small island economies. He attached considerable importance to the analysis of changes in the terms of trade and of protectionist barriers, the construction of effective exchange rate indices, and improved balance of payments statistics. Furthermore, he agreed that the Fund should pursue a more interventionist role with respect to trade restrictions, which severely impeded the effectiveness of the policies advocated by the Fund in the small island economies. He was more skeptical about the proposals with respect to aids to trade; they could not be addressed in sufficient detail in the present seminar.

Mr. Zhang noted that, as the issue of the small tropical island countries was being studied by a number of international organizations, the paper rightly did not attempt to draw definite conclusions on the definition, characteristics, and appropriate Fund policies relating to those countries. The developing island countries had some characteristics in common--smallness, insularity, and vulnerability to external shocks--that gave rise to special economic difficulties. Their smallness placed severe factor constraints on economic development; their insularity and distance from major continents made for higher unit costs of imports and exports; and their limited economic base made their entire economy vulnerable to natural calamities. Although some of those characteristics were present in varying degrees in other small developing countries, it was the combination of those characteristics that made the economic disadvantages of small island economies more conspicuous.

Nevertheless, it could not be denied that island countries generally enjoyed advantages in some sectors, notably in fisheries and tourism, Mr. Zhang continued. In a number of tropical island countries, those two sectors had been well developed and were an important part of the economy. There was no proven yardstick that could be used to weigh the inherent disadvantages of those economies against their potential advantages. In the initial stage of development, however, those disadvantages invariably outweighed the advantages, and considerable external assistance was therefore required. Special consideration should be given by the international community to the needs of that group of countries.

All but 4 of the 17 small tropical island member countries had Fund quotas of less than SDR 10 million, Mr. Zhang observed. Experience demonstrated that geographical and structural disadvantages in those countries had tended to make their adjustment process difficult and protracted; at the same time, their small quotas had limited their access to Fund resources. Those countries had made heavy use of resources available under the compensatory financing facility, owing to their susceptibility to natural disasters and their reliance on one or two crops for their foreign exchange earnings. In the past, the Fund had been rendering valuable services to those countries in the form of technical assistance. In view of their special situation, the Fund should treat such countries with flexibility. Finally, as the present study did not contain any definite conclusions or recommendations regarding future Fund policy, he agreed with Mr. Prowse that further research should be carried out.

Mr. Polak stated that it was clear from Mr. Legarda's paper that the small tropical island countries had specific economic problems. However, they also had specific economic and other advantages not dealt with in the paper. Many of the problems of the small island countries arising from their size were shared by other small countries. Some of their difficulties arose from their being tropical. Insularity was in many ways a disadvantage, but was also an advantage owing to their natural resources that could be developed for tourism. But a point that had hardly been mentioned was that many of the problems arose from their being countries. The small island countries felt obliged to accept the whole superstructure of government, which they were too small to bear. Small tropical islands that were not countries--such as the many islands that made up Indonesia or the Philippines--were not obliged to put up all the costs of government themselves. Moreover, they had automatic access to any assistance available from a central government.

Many Directors had commented on the help that the Fund could give to those countries, particularly technical assistance, Mr. Polak noted. Some additional thought should be given to that issue. He was concerned about the great attention given to statistical upgrading in Mr. Legarda's report. Did those countries really need, or, more precisely, could they afford, the kind of statistical services that the Fund expected from most of its member countries? Would it not be better for the Fund to require more limited statistics from those countries that could not maintain current national income, monthly trade, and other statistics? For example, Iceland, a small nontropical island country, produced only quarterly cost of living statistics, which appeared to be appropriate for its needs.

He was also somewhat concerned about the way in which the Fund encouraged small countries to establish central banks, Mr. Polak said. The Fund had helped the authorities to set up central banks in Vanuatu and São Tomé and Principe, countries with populations of about 100,000. Surely those countries had been better off when, prior to independence, they had not had a central bank, with the associated costs and policy risks.

It would be possible to carry out studies of other groups of Fund members, classified by some other physical characteristics, Mr. Polak went on. Landlocked and mountainous countries, both in Africa and in Europe, suffered from their own particular problems. Some countries, like Canada, suffered as a result of their excessive size. Nontropical countries had to contend with the extreme costs of cold climates. All those groups of countries had particular problems, which were not necessarily of interest to the Fund. For instance, many factors affected per capita income. Perhaps the welfare of the population in the small tropical island countries was not exceptionally low. In any event, all factors relating to raising per capita income were matters for the World Bank and the regional development banks.

He was hesitant to support any special treatment of the small tropical island countries, Mr. Polak stated. He also had some reservations about carrying out further studies of those countries, which accounted for only a small proportion of the Fund membership in terms of quotas or population. The Executive Board must consider carefully how much additional effort both the Fund and the countries in question should undertake in that connection.

Mr. Malhotra remarked that Mr. Legarda had covered much of the literature on the small tropical island countries, and had raised a number of important questions. Those countries did face special problems, and it was the combination of those problems that made their economic situation more difficult, particularly when they were struck by natural disasters. Executive Directors' views differed considerably with respect to the extent of special treatment of those countries by the Fund. In the past, some Directors had been concerned that such treatment was sought mainly through special increases in quotas. In that connection, Mr. Prowse had suggested that the issue had been partly resolved when the Executive Board had discussed the question of small-quota countries at the time of the Eighth General Review of Quotas.

Special treatment could also be accorded within the existing Fund guidelines on access to its resources, Mr. Malhotra noted. If there was general agreement among Executive Directors that the small tropical island countries did encounter special problems, the Fund management, staff, and Executive Board should consider how those problems could be addressed. In that context, it would be worth investigating the level of financial support that was usually made available to those countries when they experienced balance of payments difficulties. The need for providing sufficient Fund support had been uppermost in his mind during the discussion on quota increases for small countries. On the other hand, in spite of their low GNP and limited access to capital markets, some Directors considered that Fund support for those countries should be lower than that available for other countries.

Many of the countries under consideration had open economies and were dependent on one or two commodities for their foreign exchange earnings, Mr. Malhotra noted. They therefore were more prone to disturbances in their external accounts. The compensatory financing facility was a particularly appropriate source of financial assistance for those countries, but he wondered whether it was in fact being tapped to meet the needs of the small island economies. Since the Executive Board's consideration of the Fund's policy with respect to drawings below and above 50 percent of quota under the compensatory financing facility, the Board had not considered a case for drawings under that facility made independently of Fund-supported adjustment programs. Perhaps the Fund's policy decision on compensatory financing was being interpreted too strictly.

Meaningful adjustment in the small island economies could be achieved only in a long-term framework, Mr. Malhotra said. He endorsed the view that many of the measures that needed to be introduced in those countries were a matter of development agencies, such as the World Bank and the regional development banks. However, the Fund, the World Bank, other development institutions, and other governments should pay greater attention and be more responsive to the problems facing those countries.

The staff should take particular note of Mr. Legarda's comments on the role of monetary and exchange rate policy in the small island economies, Mr. Malhotra remarked. The design of Fund programs, the amount of assistance, and the duration of Fund-supported adjustment programs were important factors to be considered in the context of those countries. Concerning the issue of special treatment, it was important to make adequate use of the existing facilities to tackle the particular problems of the small island economies.

Many of the studies suggested by Mr. Legarda were relevant, Mr. Malhotra observed. However, he appreciated Mr. Polak's point that too many studies could put an unnecessary burden on the limited resources of the small island economies. It would, however, be useful to survey the literature available on the long-term development and macroeconomic policy issues of such economies. That survey might provide the staff with a useful background for consultations and discussions. A study of that kind would be better than burdening the small tropical island countries with too many statistics.

Ms. Bush stated that, while the papers pointed out a number of problems faced by small tropical island countries, she did not consider that those problems were peculiar to them. The paper did not make a case for special treatment of the small island economies, but special treatment was already granted to those countries in a number of areas. Eleven of the 17 countries had made purchases from the Fund, and all 17 countries had received technical assistance from the Fund. Many of the problems experienced by the small island countries were developmental and would be addressed better by bilateral and multilateral aid organizations.

She recognized that the small island countries needed to maintain relatively higher levels of reserves to protect themselves against balance of payments volatility, Ms. Bush went on. However, there were alternatives to the Fund's granting favorable treatment or establishing new financing facilities.

Protectionism was one of the greatest obstructions to economic development and viability for some of those countries, Ms. Bush agreed. In fact, protectionism was not conducive to trade or to economic efficiency in any country; all countries were therefore affected by trade barriers. The Fund, in cooperation with GATT, should continue its efforts to reduce the protectionist measures. Mr. Legarda's suggestion to establish a counter-protectionist facility, funded by major countries with trade barriers, was not an appropriate response, as many countries were guilty of protectionism, including developing countries. If there were to be such a facility, all countries with protectionist policies, and not just the major countries, should provide the funds.

She agreed with other Directors who had suggested that further studies were not called for, Ms. Bush remarked. However, greater collaboration between the World Bank and the Fund to reconcile statistical discrepancies would be beneficial.

Finally, on the problems of diversification and sectoral labor imbalances in some of the small island economies, Ms. Bush suggested that the reasons for those imbalances should be examined closely. It might be possible to make certain sectors more attractive to the labor market, in an effort to encourage economic diversification.

Mr. Finaish remarked that his constituency included the smallest of the small tropical island countries, the Maldives, with a quota of SDR 2 million. By concentrating on a group of countries with similar characteristics, management hoped that a better understanding and more appropriate policy actions, including a clearer direction for the role of the Fund, would emerge. Mr. Legarda's paper and the present discussion made a useful contribution toward that end. The small islands had certain common characteristics and problems. Owing to their smallness and insularity, they were particularly vulnerable to exogenous shocks and were severely constrained in their growth prospects. It should be borne in mind however that characteristics other than insularity and smallness might lead to similar or perhaps even greater problems.

Small island economies had a narrow productive base, narrow export concentration, and a small domestic market, Mr. Finaish noted. Although those countries had attempted to diversify their economies in order to achieve more stable growth, their plans were being continually thwarted by trade barriers, despite numerous appeals that protectionism be reduced. The Maldivian authorities had attempted to diversify by expanding into textile production; however, textile exports had been seriously hampered by a major importing country. He therefore could agree with the urgency expressed in the paper regarding the reduction of protectionist barriers.

While the paper had identified a number of similar problems faced by small tropical island countries, Mr. Finaish concluded, the discusssion had shown that issues relating to preferential treatment were complex and deserved careful consideration. The Fund could at any rate usefully study, from time to time, the specific problems of various segments of the membership as part of its efforts to promote sustainable growth for the membership as a whole.

Mr. Legarda remarked that a number of Directors' questions seemed to be related to a general misunderstanding of the purpose of the paper. He had made no categorized recommendations or suggestions, but had listed various possible courses of action, some of which had appeared in the literature, that members might wish to consider. He did not necessarily endorse them. For example, the suggestion for a counterprotectionist facility had been put forward by Mr. Wolfgang Hager, from the European Research Associates in Brussels.

With respect to one Director's request for a comparison of the openness of the small island economies with that of other groups of countries, Mr. Legarda said that he had made such comparative computations for small nonisland developing economies and had found that the results were similar on average. The operative factor seemed to be smallness rather than insularity. He assumed that the suggestion to study the concentration of foreign exchange earnings referred to commodities, and not to countries. As there were considerable difficulties in classifying commodities, and in maintaining statistical homogeneity, it was somewhat easier to compute the index of concentration by countries. He had decided not to include that issue among his suggestions for further study because of the conceptual difficulties associated with the index of concentration.

A collective approach to the problems faced by the small tropical island countries, such as the establishment of an adjustment consultative group, could be considered, Mr. Legarda went on. Such a collective approach existed in the Caribbean, although it was not confined to the small tropical island countries; it was in effect a consortium chaired by the World Bank, with the very active collaboration of the Fund.

A number of speakers had suggested the possibility of simplifying the statistical work of the authorities in the tropical island countries, Mr. Legarda recalled. Perhaps the Fund could standardize its data requirements with those of other financial institutions.

The Chairman stated that Directors had had a thoughtful and interesting exchange of views on the subject of small tropical island economies, from which the Fund staff would benefit. The Fund should not grant special treatment to the small tropical island countries, but should give special attention to their particular problems. The staff, in conducting Article IV consultations, should be particularly aware of the characteristics of those countries--their narrow economic base, vulnerability to climatic and other external shocks, and difficulties associated with diversification efforts--and should emphasize the supply-side aspect of their economic problems. Furthermore, the Fund should collaborate closely with the World Bank, because most of the problems of the small island economies were of a structural, developmental nature. A collective approach, by the regional development banks, donors, the World Bank, the Fund, and governments, would be beneficial.

Although the Fund should provide technical assistance in statistics, the Chairman noted, it was essential that the statistical requirements of the different financial institutions be simplified and standardized. While it was time consuming for the Fund staff to carry out Article IV consultations with the small tropical island countries, staff reports on recent economic developments were an essential tool for the authorities of those countries. Furthermore, consultations provided an occasion for the authorities to discuss their policy options and difficulties with the Fund staff.

He would reflect carefully on the suggestions put forward by Directors concerning possible future studies of small tropical island countries before asking the staff to embark on new avenues of research, the Chairman concluded.

The Executive Directors took note of the Chairman's comments.

LEO VAN HOUTVEN
Secretary