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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/42

10:00 a.m., March 9, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	J. A. K. Munthali, Temporary
	Song G., Temporary
	M. Lundsager, Temporary
	E. L. Walker, Temporary
	G. Seyler, Temporary
	M. Hepp, Temporary
	T. Alhaimus
	B. Goos
J. E. Ismael	
	J. Hospedales, Temporary
	M. Foot
	R. Fox, Temporary
	D. A. Woodward, Temporary
	O. Isleifsson, Temporary
M. Massé	D. McCormack
	C. V. Santos
	A. Ouanes, Temporary
	C. Noriega, Temporary
H. Ploix	
	A. van der Burg, Temporary
C. R. Rye	
G. Salehkhou	
A. K. Sengupta	A. Vasudevan, Temporary
K. Yamazaki	
	R. Manfredi Selvaggi, Temporary

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

IBRD: G. Hyde, Eastern Africa Regional Office. African Department: A. D. Ouattara, Director; R. J. Bhatia, Deputy Director; N. Abu-zobaa, J. Kakoza, S. N. Kimaro, R. H. Nord, J. C. Williams. Asian Department: P. R. Narvekar, Director; K. A. Al-Eyd, N. N. Choudhry, M. Ishihara, I.-S. Kim, I. Otani, K. Saito, S. Shah, W. M. Tilakaratna. Exchange and Trade Relations Department: E. Brau, S. M. Fries, M. O. Tyler. Fiscal Affairs Department: B. A. Sarr. Legal Department: H. Elizalde, J. K. Oh. Western Hemisphere Department: S. T. Beza, Associate Director; J.-P. Amselle, M. A. Da Costa, J. Ferrân, H. E. Khor, S. J. Stephens, M. A. Tareen, K. Thugge. Advisors to Executive Directors: A. Bertuch-Samuels, L. P. Ebrill, G. D. Hodgson, G. Pineau, I. Sliper. Assistants to Executive Directors: A. R. Al-Abdullatif, S. K. Fayyad, Hon C.-W., A. R. Ismael, M. A. Kyhlberg, V. K. Malhotra, T. Morita, A. H. Mustafa, L. M. Piantini, V. Rousset, D. Saha, G. Schurr.

1. MADAGASCAR - 1986 ARTICLE IV CONSULTATION AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1986 Article IV consultation with Madagascar and the first review under the stand-by arrangement (EBS/87/21, 2/3/87; Cor. 2, 2/6/87; Cor. 3, 3/6/87; and Sup. 1, 3/6/87). They also had before them a background paper on recent economic developments in Madagascar (SM/87/36, 2/13/87; and Cor. 1, 3/6/87).

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

> Executive Directors will have noted in paragraph 6 of the letter of intent from the Malagasy Minister that the authorities intended to increase consumer prices on all petroleum products by 10 percent before the Fund Executive Board's consideration of the program. The staff has now been informed that in view of the social tensions that have emerged recently in Madagascar, the Government proposes to delay taking this measure until no later than April 10, 1987. This delay of one month should have no adverse financial impact on the fiscal situation and only a minimal impact on the financial situation of the petroleum company.
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> A staff mission has just returned from Madagascar, where discussions were held between the authorities and Fund and World Bank staff on, inter alia, the future course of exchange rate policy. Understandings have been reached on a further significant depreciation of the rate before the completion of the second review and on subsequent adjustments through the end of the current year. It is understood that the changes in the exchange rate will be reflected in the administered prices, including petroleum prices.

Mr. Santos made the following statement:

> The Malagasy authorities' adjustment efforts were frustrated by a number of adverse developments in 1986. First, the island was struck by a cyclone in March and the damage has turned out to be more extensive than first estimated. Second, the southern part of the island has continued to be affected by a severe drought. Third, delays were encountered in mobilizing external financing on which the industrial sector is crucially dependent. In the face of these adverse developments, the Malagasy authorities strengthened the implementation of their adjustment program in the context of a stand-by-arrangement which was approved by the Board in September 1986. All the measures envisaged in the program were implemented and all performance criteria for the period under review were observed.

Mainly as a result of the adverse weather and shortage of foreign exchange to import much needed inputs, economic activity slowed down in 1986. Real GDP is estimated to have grown by less than 1 percent, compared to 2.3 percent in 1985. Despite the damage caused to plantations, the agricultural sector seems to be responding favorably to the price and market liberalization measures introduced earlier, and its output increased by about 2.3 percent in 1986. However, in the industrial sector where damage to the oil refinery was extensive, output registered a decline estimated at 1.7 percent.

Notwithstanding the additional burden of rehabilitating the infrastructure following the destruction caused by cyclone Honorinina, noticeable progress was made in the fiscal sector in 1986 where the deficit was further reduced to 3.9 percent of GDP from 4.7 percent in 1985. As a result of the impact of the devaluation on trade taxes and better collection of taxes on goods and services, total revenue increased by about 11 percent, or 3 percentage points below the program target. However, when it became apparent to the authorities that a revenue shortfall might occur due to the adverse developments in the real and external sectors, they promptly took additional expenditure-reducing measures, to bring the prospective deficit to a manageable level. These included delaying and reducing the size of the proposed wage increase to government employees and curtailing projected domestically financed capital outlays.

With regard to the public enterprises, the authorities' aim remains the complete restructuring and rehabilitation of this sector. Toward this end, prices and tariffs of the goods and services provided by some of the enterprises have been adjusted upward, the management and work force of others have been streamlined, and still others have been closed down. Moreover, to improve the efficiency of this sector, the Government is encouraging some of the enterprises to seek outside managerial assistance. The partial or total acquisition of a number of enterprises by either domestic or foreign interests is also being sought. In the meantime, in the context of a rehabilitation plan, studies were completed on a group of enterprises, and the World Bank is being approached to assist in the implementation of the recommendations.

Monetary and credit policies in 1986 were prudent. They reflected the lower level of economic activity as well as the authorities' objectives of controlling inflation and improving the balance of payments position. The structure of credit allocation also indicates the authorities' desire to allocate more resources to the private sector of the economy. To that effect, and within the overall plan of improving the finances of the public enterprise sector, control over the borrowing of public enterprises was imposed in 1986.

In the external sector, developments were characterized, as in previous years, by the continued reduction in imports and the increased burden of the servicing of the external debt. The volume of imports in 1986 is estimated to stand at about 60 percent of the level reached in 1980, while the servicing of the external debt is now absorbing more than 50 percent of the receipts from export of goods and services. Concerned at this continued deterioration in the external sector, the Malagasy authorities decided during 1986 to implement a comprehensive reform of the export sector. In the second half of 1986 the export regulations were revised and simplified and all prior controls over export prices were removed. Furthermore, the Malagasy franc was devalued by 20 percent in August and a policy of adjusting the rate quarterly has been put in place. Export receipts increased in 1986 but were below initial projections, mainly as a result of lower export prices of the main commodities and some loss of stocks due to the cyclone. On the import side, the downward trend continued because of delays in mobilizing external financing. The capital account, however, benefited from the rescheduling of debts from official and commercial creditors and showed an appreciable increase over the 1985 level. As a result, a small improvement in the balance of payments position is estimated for 1986.

With regard to the rice management program, my Malagasy authorities are as disappointed as the staff at the fact that the objectives set for rice have not been attained. To appreciate the problem, one needs to view it in its proper context. First of all, reforms in the rice sector were started only in 1983, and the World Bank involvement in the rice management program began in 1985. Although some progress has been made in the area of price and market liberalization, production has not yet been in line with expectations partly because of weather-related problems. Rice imports, which declined from 1982 to 1985, increased in 1986. This increase was consistent with the provisions of the Agricultural Sector Adjustment Credit approved by the World Bank because of the requirement of the food security stock. The authorities would like to see domestic production increase and they are making every effort in that direction but until this happens, they will need to continue to import rice to supplement domestic production. Any further reduction in the amount available for consumption can only lead to unacceptable social consequences.

The main concern of the authorities remains the slow growth of the economy, which has led to a decline in per capita income with its related social consequences. During 1987, the Malagasy authorities intend to continue to follow economic policies aimed at restructuring the economy so as to stimulate growth and exports. Emphasis will remain on supply-oriented measures while maintaining a prudent demand-management stance. Efforts will also be directed at removing structural rigidities that are hampering growth and at allowing market forces to play an increasing role in the allocation of resources.

In the real sector, the authorities plan to reinforce the market liberalization process through a gradual easing of controls on profit margins in the wholesale and retail trade. In addition, the system of marketing of vanilla, pepper, and coffee will be reviewed with the World Bank with the aim of providing more incentives to middlemen to operate in remote areas. These measures, together with the reactivation of the oil refinery and a more efficient allocation of imports in the industrial sector, are also expected to contribute to real GDP growth in 1987.

Fiscal and monetary policies are expected to remain tight in 1987. In the fiscal sector, the authorities plan to take additional measures to raise revenue. These measures include, among others, a 10 percent increase in petroleum prices, the introduction of a value-added tax on telecommunication services, and increases in the wholesale price of flour. These, together with the full year effect of the devaluation and the fee on import licenses are expected to lead to a significant improvement in government revenue. On the expenditure side, the authorities will maintain their strict policy of control. It is expected that with these measures in place, the fiscal deficit will continue to decline in 1987. In the monetary sector, increases in the components of monetary aggregates will be kept below those of 1987, and interest rates on deposits have been increased. Furthermore, and in order to improve their control over monetary policy, the Malagasy authorities plan to introduce a reserve requirement system for banks and to offer treasury bills to the public in 1987.

In the external sector, policies in 1987 will be geared toward providing the needed impetus to encourage exports, especially nontraditional exports. In that context, and in view of the difficulties producers, and thus exporters, have encountered in acquiring foreign exchange to import critical inputs and spare parts, the authorities introduced a liberalized system of imports in January 1987 to supplement the measures already taken to facilitate exports. This new, liberalized regime which is described in paragraph 17 of the letter of intent is expected to enhance the role of market forces in the allocation of the limited amount of foreign exchange that is available for imports. It is hoped that these measures, together with a flexible exchange rate, will contribute to the improvement of the external sector.

To conclude, the Malagasy authorities have demonstrated their willingness to persevere with the adjustment program in spite of the social disturbances that some of these measures (such as substantial increases in the price of foodstuffs) are causing. The continued deterioration in the standard of living since 1981 has compounded these problems. It is therefore of paramount importance that economic growth be strengthened and sustained. This would require timely and substantial foreign financial assistance to enable the country to sustain an appropriate level of imports. In the meantime, they are thankful for the assistance already provided by the Fund, other financial institutions, and friendly countries. It is their hope that their past performance and the measures they are taking now will encourage donors and creditors to continue to support their adjustment efforts with additional funds.

Mrs. Ploix made the following statement:

The report on the first review under the stand-by arrangement with Madagascar shows the seriousness with which the Malagasy authorities have implemented the program supported by the Fund. I wish to commend them for their commitment. I shall not elaborate on the measures that have been implemented; they are well described in the staff report. Rather, I shall focus on the future and make a few recommendations.

Madagascar has reached a turning point in its adjustment process: six successive stand-by arrangements, in spite of real sacrifices, have not succeeded in increasing production or improving the balance of payments. This lack of improvement has induced the authorities to adopt a faster pace in introducing new reforms within the current stand-by arrangement, an approach supported by the World Bank, which is currently contemplating a trade and industry loan. We too feel that a more intensified approach is called for, but I would like to qualify my support somewhat. First, we must refrain from too simplistic an analysis of the problems. The implementation of macroeconomic policies alone will not automatically increase industrial and agricultural production. Madagascar's economy is not an abstract economic model, and in order to ensure the efficiency of macroeconomic policies, it is essential that they be complemented by carefully designed microeconomic measures. My point can best be illustrated using agricultural production as an example. The agricultural inelasticity and output, especially of rice, stems from a variety of cumulative factors, among which producer prices represent only one element. Accordingly, any action on prices must be supported by, inter alia, agricultural training, the provision of inputs, transportation, marketing, credit, and the provision of consumer goods to rural producers.

My second point concerns the consistency of the program, which is particularly important in the industrial sector. It is difficult to see how the industrial sector can develop in present circumstances of a lack of foreign currencies--which places heavy constraints on imports--and a very low level of domestic demand. Growth in the industrial sector requires a relatively high level of imports of capital goods and the development of domestic demand. These requirements and the requirement of adjustment call for delicate arbitration.

On the role played by the state in liberalization, I note that in the design of adjustment programs, we often refer to the virtues of a return to market mechanisms. It should be kept in mind that, in Madagascar's case, it is not so much a return to the rules of the market that should be looked for, since the market has many flaws due to transportation discrepancies and intermediation problems; indeed, in some respects, it may be said the market has never existed. In order to liberalize, the state must create a free market and ensure that no dominant position or undue speculation prevail on it. I fully share the views expressed in the report regarding the need to eliminate the numerous administrative impediments to the development of production, trade, and exports. Once again, however, the issue of the balance of the state's role is a matter of judgment.

The authors of the staff report are well aware of the delays involved in adjustment in Madagascar. Indeed, explicitly mentioned in the staff appraisal is the statement that "it might take some time before the full impact of the supply-oriented measures will be felt." There are several conclusions that can be drawn from this statement about import and exchange rate policies and about the financing needed to support the adjustment process.

With regard to import and exchange rate policies, it is important to remain pragmatic. Indeed, a complete liberalization of the exchange system with no restrictions on imports could lead to unpredictable effects on an economy that has only limited ability to react quickly in the production and export areas. A gradual approach would therefore appear fully warranted. On this issue, I would be glad to have some comments from the staff. A new system was introduced in January 1987, and I wonder whether that introduction was the first step in a calculated strategy whether the new system will now be completely modified.

As for the required financing for the adjustment process, it is clear that such support is central to the success of adjustment. There will be no breakthroughs in Madagascar's development without adequate financing for imports. I am therefore most encouraged by the interest shown by the World Bank in broadening its operations. I would be interested in any information on the recent discussions with the authorities and on the prospects for the expansion of World Bank activities in Madagascar. In addition, I note that Madagascar has reached a point at which consideration of an arrangement under the structural adjustment facility is fully warranted, and I wonder what the prospects are for such an arrangement.

Finally, I would like to emphasize that the success of this program requires the collaboration of all parties including, first and foremost, the Malagasy authorities themselves. I encourage them to intensify their efforts to remove structural bottlenecks and administrative impediments to prices, imports, and exports. I encourage them also to go ahead with the reform of the public sector enterprises and the banking system and to create an environment more favorable to private sector investment.

The success of this program will also depend upon the concerted action of the Fund and the World Bank and upon their ability to design adequate macroeconomic measures. The credibility of this program is vital, given the weariness of the population with respect to adjustment efforts. I am confident, nevertheless, that these difficulties can be overcome.

Ms. Lundsager made the following statement:

The staff supplement provides a welcome update to the report on the implementation of the stand-by arrangement. We continue to be discouraged with the still low growth rates in Madagascar, as we had noted at the Board discussion of Madagascar in September 1986. Of course, to some extent this is due to the effects of the cyclone last year, but it does serve to reinforce our earlier emphasis on the need for wide ranging structural reforms in Madagascar. In that regard, we are encouraged by this report that efforts are being made to generate export diversification and growth through a flexible exchange rate policy, accompanied by producer price increases (coffee) and actions to open export activity to private traders as well (pepper). We agree that emphasis needs to be placed on nontraditional exports, and we wonder what measures besides the exchange rate commitments will facilitate export expansion. In particular, are incentives for foreign investments being considered, perhaps to promote light manufacturing for export? An important adjunct to these measures is the ongoing liberalization in the domestic profit and price control system, which is needed to ensure that international comparative costs are reflected in the domestic pricing structure.

These issues are related to several other crucial structural reforms currently under way, including the relaxation in the import regime. With these reforms, more market-based importing decisions can be encouraged through the expansion of access to imports to a wider range of private sector entities. On the rehabilitation of the public entities, we noted that the 14 targeted entities will still need an injection of FMG 12 billion to turn a loss of FMG 0.3 billion to a profit of FMG 4.3 billion. I hope we can surmise that this seemingly poor trade-off will generate a net benefit over the medium term, although we would appreciate staff confirmation of the longer-run profitability of these entities and comment on the prospective need for additional cash infusions. We take it this might be related to additional price deregulation, permitting a fuller reflection of costs in the pricing structure of these entities. We would, in addition, welcome an update on the progress toward privatization, with specific reference to any possibilities for foreign participation in this process, as suggested in Mr. Santos's statement.

Supportive measures are being taken in the tax field as well, with some reductions occurring in the company profits tax. Other specific measures are aimed at further containing the fiscal deficit, and we appreciate the implementation of a strict recruitment policy. Monetary policy must of course be supportive of this stance. We particularly welcome the emphasis on containing the public entities' absorption of domestic credit, and we wish to see adequate credit provided to what we hope will be a growing private sector. In addition, the commitment to maintain interest rates at positive real levels will be helpful to the payments position as well as to increasing the domestic savings rate overall. The initiation of treasury bill sales to the private sector also broadens the possible scope for monetary policy.

One additional structural issue is the financial sector reform, which appears critical to supporting the monetization of the economy while maintaining confidence in the existing structure of institutions. This matter is being indirectly addressed through the limits on credit expansion to the entities, which has been a major problem relating to the weak balance sheets of the banks. We would, however, welcome a brief comment on additional steps planned.

In conclusion, we can support the proposed decisions, and we hope in the near future to see the adoption of a structural adjustment facility program that could support the broadening and deepening of the structural reforms being initiated under this program. Furthermore, as we have noted in the past, structural adjustment financing strikes us as better suited to the overall financing needs and debt servicing burden of Madagascar. In particular, Table 7 of the staff paper is quite illuminating, in that it goes so far as to hypothesize that future Paris Club relief, on the same terms as past relief, will not fully eliminate the financing gaps, which indicates to us that a determined effort to promote exports will be needed, together with an emphasis on highly concessional sources of financing, to bring about a reduction in the debt-servicing burden. Perhaps accelerated structural reforms could also generate a higher level of World Bank financing over the medium term, and any comment that the Bank staff could provide on that matter would be appreciated, including comment on the possibility for a structural adjustment loan later this year, a possibility that had been hinted at during our Board meeting in September.

Mr. Goos made the following statement:

I should like to commend the authorities for their good performance under the current Fund arrangement and especially for the steps they have taken in the area of structural reform. This performance and the continued close adherence to the program objectives are especially praiseworthy, bearing in mind the adverse external and domestic developments the authorities had to face in 1986 and which are described in Mr. Santos's helpful statement. In this context, I also welcome the information provided in the supplementary paper on the implementation of recent policy undertakings. This information, in general, together with the further depreciation of the exchange rate and the recent agreement with the staff on future exchange rate policy are further welcome indications of the authorities' continued commitment to adjustment.

Notwithstanding the positive developments I have mentioned, the continued erosion in per capita income and the precarious balance of payments outlook leave little doubt that there is no realistic alternative for the authorities but to push ahead with structural adjustment, accompanied by very cautious demand management policies. The necessity for such an approach is again appropriately emphasized in the staff appraisal, which, with remarkable clarity, reveals one of the major shortcomings of previous adjustment efforts, namely, the insufficient emphasis on overcoming the structural impediments to higher exports and overall growth. It is quite sobering to note from the staff report that, even after six successive Fund arrangements, there remain "pervasive bureaucratic impediments to private sector activity (and) to external trade" and that there is still no "economic environment and regulatory framework" in place that could be regarded as "conducive to domestic and foreign private sector investment." Equally disappointing--if not more so, given so many Fund-supported adjustment programs--is the staff's observation that only "a beginning has been made toward liberalizing exports and reducing restrictions on imports." I therefore join the staff and others in urging the authorities to formulate without delay a comprehensive medium-term adjustment strategy that could be supported by an arrangement under the structural adjustment facility. Such an arrangement--through the concessional terms of structural adjustment facility resources--could also help improve the profile of the Fund's exposure, thereby alleviating somewhat my concerns about Madagascar's ability to service its financial obligations to the Fund.

On specific aspects of the program for 1987, I feel that the thrust of the policies and measures contemplated points in the right direction. In general, however, considering the need to strengthen the growth potential of the economy and minimize the substantial financing gaps that remain uncovered in the external balance of payments on the basis of present policies and projections, I feel that the authorities would be well advised to accelerate the pace of structural reform wherever possible. This applies in particular to foreign trade, which, while it was undergoing a welcome simplification of administrative controls, was witnessing little more that could be regarded as genuine liberalization, with the notable exception of the elimination of export price controls undertaken in the second half of 1986. In this context, I should explicitly welcome the authorities' efforts to avoid renewed slippages in the rice import target so as to protect the trade account and the already very low levels of essential imported inputs. While this would require continued monitoring and, if necessary, adjustment of rice production incentives, I should like to recall the recommendation expressed at the time the program was approved that the authorities might consider the elimination of the monopoly of domestic rice purchases as a further means of improving the domestic supply of rice.

Another area where I would recommend continued attention is the area of interest rate policy, which should aim at maintaining positive real rates both for lending operations and for deposits. This should apply as well to interest rates on treasury bills, after allowing for taxation, in order to make them an effective instrument for absorbing part of the existing excess liquidity in the economy. I also welcome the progress realized in decontrolling prices, together with the authorities' commitment to liberalize profit margins. In view of the importance of such liberalization for strengthening private sector initiative, I would recommend an aggressive approach in this area, which should of course be supplemented by the kind of additional measures mentioned by Mrs. Ploix, such as the provision of inputs, extension services, and so on.

Finally, on fiscal policy, while welcoming the further reduction in the deficit envisaged for 1987, I am concerned about the intended substantial increase in the number of government personnel. Rather than stepping up recruitment, I would have thought it more appropriate in the precarious circumstances of the country for the authorities to look for a smaller, better paid--and in all likelihood, therefore, more efficient--civil service. Perhaps the staff would care to comment on that point as well as on the progress toward the intended tax reform. In conclusion, I can endorse the staff appraisal and support the proposed decisions.

Mr. Ouanes made the following statement:

I am pleased to see from the staff report and from Mr. Santos's helpful statement that the program with Madagascar is on track, and I would appreciate confirmation of the indication in the report that all performance criteria for both end-September and end-December 1986 have been met. I commend the authorities for maintaining the momentum of adjustment and for implementing all policy measures envisaged under the program. I also welcome the most recent moderation in the inflation rate and the improved competitive position.

However, I am concerned about the potentially adverse impact on the Malagasy economy of a further significant weakening in the international price of coffee. I would welcome staff comment on the implications of these developments for the financing gaps for 1987 and 1988. Given Madagascar's heavy reliance on coffee exports and the country's already high external debt burden, the authorities should monitor the situation closely.

I very much welcome the role the World Bank is playing in the agricultural sector. Improving the cropping pattern and attaining self-sufficiency in rice by 1990 are two important objectives in the overall restructuring of the Malagasy economy. Self-sufficiency in rice will free scarce foreign exchange resources, enabling the country to increase imports of needed capital goods and strengthen the country's capacity to service its mounting external debt. It will also contribute to the buoyancy of the agricultural sector and to the growth, employment, and improved welfare of the rural population. As indicated in Table 7 of Appendix II of the background paper, the authorities have already made considerable and commendable progress in this area. I urge them to stay the course and, indeed, to intensify their efforts by providing the needed incentives to achieve this important objective. Staff comment on the feasibility of their doing so by 1990 would be helpful.

With respect to the broad objectives of the present program, I welcome the emphasis placed on increasing economic efficiency, enhancing competitiveness, and allowing market forces to play a greater role in allocating resources. However, while substantial progress has been made in liberalizing the economy over the past few years, much remains to be done. In particular, administrative procedures and "red tape" need to be further reduced so as to foster an environment conducive to greater private sector participation in the economy. I understand that the authorities are in the process of requesting a structural adjustment facility program, and I would hope that a broad economic liberalization and streamlining of present administrative procedures would be further emphasized in that program. Finally, I wish to compliment the authorities on their success in rebuilding foreign reserves.

The current level is reasonable, and I hope that it will encourage the authorities to accelerate the pace of reducing their external arrears.

In conclusion, I urge the authorities to be especially vigilant in 1987 and to avoid any interruption or relaxation of their adjustment efforts. I wish them well and support the proposed decisions.

Mr. Munthali, indicating his chair's support for the proposed decision, said that he wished to associate himself with the remarks of Mrs. Ploix. In particular, he had been persuaded by her views on the use of, and role played by, import and price liberalization measures in situations where the underlying economic structure was characterized by rigidities that hindered economic efficiency. In prescribing such measures, the Fund should endeavor to exercise realism in each individual case in order to take account of second-best solutions.

The staff representative from the African Department, responding to queries about a possible structural adjustment facility arrangement with Madagascar, informed Directors that the Malagasy authorities had asked the staff to discuss with them during the second review under the stand-by arrangement a policy framework paper and an arrangement that could be supported by structural adjustment facility resources. The delay of the Malagasy authorities in approaching the Fund with such a request had been due to their desire to first hold discussions with the World Bank on the proposed industrial and trade policy adjustment credit, which would be negotiated in Washington toward the middle of April.

Agreeing fully with the views of Mrs. Ploix on the structural constraints of the Malagasy economy, the staff representative observed that macroeconomic policies were in fact being implemented. However, one could not expect those policies to result in a turnaround of the economic situation in Madagascar so long as the structural constraints remained. The Fund staff had been able to identify some of those constraints, and the World Bank had identified others. It was clear that the simplification of restrictions on exports and the limited liberalization of imports that had been introduced in Madagascar were positive steps toward eliminating those constraints. In that respect, he could also support Mrs. Ploix's view that industrial production could not be expected to increase in the absence of sufficient imports of raw materials and spare parts. It should perhaps be noted that the amount of foreign exchange allocated monthly for the imports of raw materials and spare parts was larger than it had been in the past. The limited import liberalization scheme that had been introduced in Madagascar was only a temporary system, which would be replaced during the course of 1988 by a more generalized open licensing system.

In response to a question by Ms. Lundsager, the staff representative observed that pricing measures--in addition to the recently introduced investment code--should go a long way toward encouraging exports.

Ms. Lundsager had also asked about the profitability of the public sector enterprises. It should be noted that the infusion of FMG 12 billion was to be only a one-time action, with the 14 public sector enterprises targeted for support expected to return to profitability thereafter. Undoubtedly, of course, there would be other enterprises that would need to be rehabilitated in future, and that would require additional resources; but, for the time being, only the FMG 12 billion had been earmarked. Progress toward privatization had been made, although mostly foreign firms had been invited by the Malagasy authorities to participate in a few existing enterprises with their know-how and financial resources.

The rehabilitation of the public sector enterprises was an essential step toward the reform of the banking system, the staff representative considered. The three government owned and controlled commercial banks would again be audited in the course of 1987, with a view to identifying all nonperforming loans. Thought had been given to the idea that the nonperforming loans might be taken over by the Central Bank or the Government as a way of improving the financial health of the banking system, although no steps toward that end had been initiated. In the context of the second review of the stand-by arrangement, the authorities were planning to put forward ideas about how to enlarge the banking system and to make it more competitive.

It was expected that a structural adjustment loan from the World Bank would be provided sometime in 1988, the staff representative continued. The industry and trade adjustment credit that would be negotiated in mid-April between the Malagasy authorities and the World Bank was an important step in that direction.

In response to a question from Mr. Goos, the staff representative observed that the monopoly for public enterprises to purchase rice had been eliminated, and trading in rice was completely free in Madagascar. Indeed, prices were pretty much determined by the market. It should perhaps be noted that under the World Bank agricultural sector adjustment credit, the Government could sell rice at a fixed price for low-income groups; however, that arrangement did not entail any financial subsidies from the Government.

Treasury bill rates in Madagascar would be even higher than the minimum rates offered on 6-month and 12-month deposits in order to create an instrument that would be attractive to the private sector, the staff representative commented. In the event that those treasury bills were not fully subscribed by the private sector, the Central Bank would stand ready to take up the remainder, but it would reduce credit to the Government by an equivalent amount; hence, the arrangement would not entail any increase in government indebtedness to the banking system. On the matter of profit margins, the staff had recently received from the authorities an indication of the commodities being liberalized. Of course, it was difficult in an economy like that of Madagascar to eliminate profit margins overnight, but the first steps had been taken. According to the agreement with the authorities, profit margins on most commodities--with the exception of those in the sensitive areas such as foodstuffs--should be fully eliminated by June 1988; and at least 50 percent of the controls on profit margins of commodities should be eliminated by end-1987.

In response to Mr. Goos's concerns about the increase in government employees, the staff representative observed that the increase--500 out of 129,000--was less than one half of 1 percent, which did not seem unreasonable. The Government would need to continue to recruit university graduates for highly qualified positions, although there had not been much recruitment for the lower grades and clerical staff.

On the matter of tax reform, a mission from the Fiscal Affairs Department of the Fund would depart for Madagascar within a few days with a view to examining with the authorities tax measures that would reduce dependence on revenue derived from export-related taxes, the staff representative said. On another matter, he wished to confirm that the performance criteria for end-1987 had been met, and with the completion of the current review, Madagascar would be able to purchase from the Fund some SDR 5 million.

A number of Directors had touched upon the international price of coffee and its implications for Madagascar's economy, the staff representative recalled. The balance of payments projections assumed a reduction in the price of coffee in 1987 of only 10 percent. In fact, the reduction as calculated at present was approximately 23 percent, which meant that, on the coffee account alone, the financing gap in the projections would increase from SDR 13 million to about SDR 30 million. However, the staff had not taken into account in its projections possible increases in capital inflows from bilateral sources on the order of SDR 15 million. Nor had it taken into account any recourse by Madagascar to the Fund's structural adjustment facility or the loan from the World Bank. If those compensating factors were taken into account, there would be no financing gap in 1987. Of course, the staff was concerned about the reduction in the international price of coffee. The authorities had reached an agreement with the World Bank on a 30 percent increase in producer prices for coffee in 1987/88 so as not to discourage production.

The staff continued to believe that the timetable for the elimination of arrears was realistic, even though there was no firm agreement with the authorities on that point, the staff representative commented. On a related matter, Directors should be informed that freely available reserves had increased substantially in the course of 1986; by end-December, they had reached a level of SDR 40 million. In his view, it would not be advisable for the authorities to use those reserves in order to reduce arrears substantially. It would be better to use the resources to import the inputs necessary to give some push to the industrial sector.

Mr. Santos, thanking Directors for their constructive remarks on the economic and financial policies of Madagascar, assured his colleagues that their views would be conveyed to his authorities. He had little to add to the staff's replies, except to emphasize one or two points. First, in recognition of the disappointing performance of the Malagasy economy, the authorities were emphasizing supply-side measures in the current program. They were preparing a medium-term economic strategy aimed at a further restructuring of the economy and improved efficiency and they hoped that progress toward those ends could form the basis for a program to be supported under the structural adjustment facility.

Radical measures were being adopted by the authorities with a view to improving performance in the external sector, Mr. Santos continued. However, until their full effect was felt, adverse exogenous developments--such as poor weather conditions and further declines in the world price of Madagascar's main export commodities--could lead to a worsening in the balance of payments position. Mrs. Ploix had correctly pointed to the structural impediments in the economy, and the Malagasy authorities hoped that the liberalization measures being introduced would help to overcome those impediments. It should be recognized, of course, that such changes would take time to effect. Finally, he wished to assure the Board that the authorities were fully committed to the adjustment program, even in the face of strong social pressures. They hoped that international institutions like the Fund and the World Bank would continue to support their efforts and would show pragmatic understanding of the approaches being adopted.

The Acting Chairman made the following summing up:

Directors were in broad agreement with the thrust of the staff appraisal in the report for the 1986 Article IV consultation with Madagascar. They commended the authorities for implementing the adjustment programs supported by recent stand-by arrangements with the Fund, notwithstanding adverse exogenous developments. However, Directors noted that after six successive arrangements, economic growth continued to be sluggish, as reflected in weak exports and continuing balance of payments difficulties. More generally, it was suggested that the experience of Madagascar in recent years provided evidence that macroeconomic policies alone will not be sufficient to promote economic growth in the absence of adequate microeconomic policy changes. In this context, careful attention would need to be paid to the evolving relationship between the role of the private sector and the role of the state in Madagascar. Looking to the future, Directors stressed the urgency of accelerating progress in restructuring the economy and diversifying the export base--in particular by encouraging non-traditional exports--while continuing to pursue policies to contain aggregate demand and ensure external competitiveness.

Directors urged Madagascar to move rapidly to an equilibrium level of the exchange rate that would permit a larger portion of imports to be made under an open general license system in 1988.

They cautioned, however, that an appropriate exchange rate level was a necessary but not sufficient condition for a significant improvement in economic growth and export performance over the medium term. Directors encouraged the authorities to move vigorously to remove existing structural bottlenecks and to continue to dismantle impediments to private sector economic activity, in particular, those to external trade. They observed in this context that sufficient foreign resources would have to be made available to permit the imports necessary to support the structural reform effort. Directors noted the need for reform of the banking system in order to improve the mobilization of small savings and the provision of medium- and long-term credit for financing investment.

Directors welcomed the continued progress in the reduction of fiscal imbalances. They noted the continued decline in the overall treasury deficit and that, for the first time, the Government would reduce its indebtedness to the banking system. Observing that a study of ways to improve fiscal management and achieve tax reform was under preparation, with external technical assistance, Directors urged that the recommendations of the study be integrated into the next budget exercise. With regard to monetary policy, some concern was expressed at the rather rapid expansion in broad money during 1986, as such expansion could lead to an increase in inflationary pressures.

Directors expressed concern at the slow progress in reducing the size and improving the efficiency of the public enterprise sector. They urged that the rehabilitation plans for the 14 enterprises for which prediagnostic studies were completed in 1986 be implemented. Directors felt that the tight subceiling on credit to public enterprises was appropriate, and they urged that the monetary authorities ensure that the banks strictly abide by existing directives and no longer finance the operating losses of enterprises.

Directors welcomed the introduction of a program to progressively dismantle controls on profit margins for wholesale and retail trade. They urged that further steps be taken to resist or reduce existing marketing rigidities and to improve extension services, particularly with respect to agricultural commodities and other goods destined for export. They also welcomed the agreement with the World Bank on rice sector policies for 1987.

Directors expressed grave concern that Madagascar's growth and balance of payments prospects will remain difficult through the 1990s. This underscored the need to move rapidly to formulate a comprehensive adjustment strategy that could be supported by arrangements under the structural adjustment facility. Directors stressed that the World Bank and other international and bilateral development institutions may be expected to play an increasingly important role in support of Madagascar's adjustment efforts. They urged that financial assistance from the donor community on appropriately concessional terms continue to be forthcoming.

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

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Madagascar's exchange measures subject to Article VIII, Section 2, and in concluding the 1986 Article XIV consultation with Madagascar, in the light of the 1986 Article IV consultation with Madagascar conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. As described in EBS/87/21 and in SM/87/36, the restrictions on payments and transfers for current international transactions are maintained by Madagascar in accordance with Article XIV, Section 2, except that the restrictions in the form of foreign exchange budgeting for current international transactions and specific limits for certain invisible payments are subject to Fund approval under Article VIII, Section 2(a). The Fund welcomes the intention of the authorities to remove progressively the exchange restrictions in the context of the adjustment program supported by the current stand-by arrangement. In the meantime, the Fund approves the retention of the restrictions that are subject to approval until September 30, 1987, or the completion of the second review under the current stand-by arrangement, whichever is earlier.

Decision No. 8546-(87/42), adopted
March 9, 1987

Review Under Stand-By Arrangement

1. Madagascar has consulted with the Fund pursuant to paragraph 4(b) of the stand-by arrangement for Madagascar (EBS/86/201, Sup. 1, 8/25/86) in order to establish performance criteria for 1987 as contemplated in paragraph 23 of the letter dated July 25, 1986 from the Minister at the Presidency in Charge of Finance and Economy.

2. The letter dated December 2, 1986 from the Minister at the Presidency in Charge of Finance and Economy shall be attached to the stand-by arrangement for Madagascar, and the letter dated July 25, 1986 attached to the stand-by arrangement shall be read as modified and supplemented by the letter of December 2, 1986.

3. Paragraph 4 of the stand-by arrangement with Madagascar shall read as follows:

"4. Madagascar will not make purchases under the stand-by arrangement that would increase the Fund's holdings of Madagascar's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of supplementary financing or borrowed resources beyond 12.5 percent of quota:

(a) During any period in which the data at the end of the preceding period indicate that:

(i) the limit on net domestic credit described in paragraph 14 of the letter dated December 2, 1986; or

(ii) the limit on net domestic credit to the Government described in paragraph 14 of the letter of December 2, 1986; or

(iii) the limit on gross credit to public enterprises described in paragraph 14 of the letter dated December 2, 1986; or

(iv) the target for the reduction of the stock of external payments arrears in accordance with the amounts set forth in paragraph 19 of the letter dated December 2, 1986 is not observed; or

(v) Madagascar incurs external payments arrears after August 1, 1986; or

(b) during any period in which:

(i) any of the limits on contracting, or guaranteeing of external debt described in paragraph 20 of the letter of December 2, 1986 are not observed; or

(ii) the limit on disbursement of medium- and/or long-term loans described in paragraph 20 of the letter of December 2, 1986 is not observed; or

(c) during any period after May 30, 1987 and October 30, 1987, until the reviews contemplated in paragraph 23 of the letter of July 25, 1986 attached to the stand-by arrangement have been completed and suitable performance criteria have been established, or after such performance criteria having been established, while they are not being observed; or

(d) during the entire period of this stand-by arrangement, if Madagascar:

(i) imposes or intensifies restrictions on payments and transfers for current international transactions, or

(ii) introduces or modifies multiple currency practices, or

(iii) concludes bilateral payments agreements that are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Madagascar is prevented from purchasing under this stand-by arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Madagascar and understandings have been reached regarding the circumstances in which such purchases can be resumed."

4. The Fund finds that the first review contemplated in the original paragraph 4(b) of the stand-by arrangement has been completed, and that no additional understandings are necessary.

Decision No. 8547-(87/42), adopted
March 9, 1987

2. MALDIVES - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Maldives (SM/87/31, 2/9/87; and Sup. 1, 3/6/87). They also had before them a background paper on recent economic developments in Maldives (SM/87/49, 2/17/87).

Mr. Alhaimus made the following statement:

Over the past several years the Maldives economy has managed to maintain a fairly high rate of growth of nearly 10 percent, and a modest rate of inflation. Considerable improvements in the fiscal and external balances were realized during the same period. These achievements are particularly significant for a small open economy which is spread over 1,200 islands, and with all the vulnerability which that entails. The main traditional activity is still centered on fisheries, where output has fluctuated widely from one year to another. Even tourism, the other major and thriving industry, is not immune, as recent events have shown, from unpredictable events well beyond the control of policies. External assistance has played a major role in helping the country overcome these inherent weaknesses and develop its potential resources. The proper utilization of this assistance and prudent economic policies in general have been key factors in the good economic performance in recent years.

The vulnerability of the Maldives economy was clearly manifest in 1986 when real GDP growth dropped to 4 percent, from about 15 percent annually during the previos two years. This was mainly due to bad weather conditions, which reduced the fish catch, and an airline incident that discouraged tourism. The authorities, however, have continued their policy of strengthening and expanding these sectors, while encouraging new activities to enhance the economy's ability to withstand unexpected developments. It is worth noting that in the preceding two years' fish catch nearly doubled in response to various improvements (including mechanization) and better incentives, such as the 20 percent rise in procurement prices late in 1985. Canning facilities were also upgraded and expanded, and two large projects to improve fishing infrastructure are being implemented. In the tourism sector, various investments are being made by both the public and private sectors for upgrading present facilities, expanding tourist resorts, enhancing promotional activities, and training local staff to ease the skilled manpower shortage. The growth of tourism has also prompted improvements in the agricultural sector which, despite its natural limitations, can still benefit from an expanding local demand. Measure were also taken to improve productivity in the garment industry, and a training scheme has been initiated for the shipping services.

In the financial sector, the adverse developments in 1986 have led to a substantial widening of the fiscal deficit, reflecting difficulties in adjusting expenditures as well as lower revenues associated with the sluggishness of economic activity. The lower than expected inflow of foreign grants was also a factor. The actual outturn for 1986, however, showed a substantially lower than budgeted deficit, reflecting mainly cuts in capital expenditures. The outlook for 1987 is for an improved revenue situation, reflecting new revenue measures, the overall pick-up of economic activity and a substantial increase in foreign grants. However, an increase in capital outlays is expected to exert added pressure on the fiscal position in 1987. The authorities, therefore, recognize the need to contain the wage bill and to ensure that investment programs are consistent with the country's absorptive capacity and the availability of foreign assistance. Toward that end, the authorities intend to pursue recommendations suggested by the World Bank staff on investment priorities.

Monetary policy in 1985 and 1986 remained on the same tight course of the past several years with further tightening measures taken in mid-1985 to moderate the rate of liquidity expansion and to stimulate the flow of credit to priority sectors of the economy. These measures, which for the most part were maintained during 1986, have led to a slower rate of overall credit expansion, as credit to the private sector declined and growth of credit to the public sector decelerated substantially. The liquidity growth rate was also much lower during 1986. The authorities recognize that the private sector has borne the brunt of tight credit policies; but, given the strong demand for foreign exchange and the limited instruments available to them, they had no other viable alternative. The authorities expect, however, that there will be less need for credit control with the adoption of adjustment measures in other policy areas.

Credit control was among the factors that reduced the impact of falling proceeds of fish exports and tourism on the current account of the balance of payments in 1986. Together with the import licensing scheme, it helped restrain import demand and, with the combined effect of the rise in re-exports and aid disbursement, it helped limit the current account deficit to 8 percent of GDP. Overall, however, the balance of payments registered a much higher surplus than in 1985, reflecting mainly private capital inflows, faster loan disbursements, and rescheduling of some debts. The authorities' strategy to improve the current account balance was not intended to rely solely on import compression. In addition to concerted efforts to expand fisheries and tourism mentioned above, the authorities have also pursued flexible exchange rate policies in the past two years by allowing the rate to depreciate, thus reversing the appreciating trend of the early 1980s. More recently, and despite initial concerns regarding the impact on the inflation rate and income distribution, the authorities have taken a major step in allowing the exchange rate to float freely. This system, which took effect on March 1, 1987, yielded a mid-rate of 10.1 rufiyaa per U.S. dollar compared with a level of just over 7 rufiyaa per U.S. dollar during the most recent period.

With regard to the import licensing scheme, the authorities have also indicated that applicants are no longer required to be engaged in foreign-exchange earning industries or to divulge evidence of foreign exchange financing from the banking system. Thus, effectively, the import-licensing scheme no longer involves exchange restrictions.

These measure will certainly contribute to a further improvement in prospects of the current year and beyond. Already, prospects for 1987 have been judged to be favorable, with the expected recovery of fisheries and tourism leading to a possible rate of GDP growth of 7-8 percent. The medium-term outlook of the balance of payments also seems to be sustainable, especially with a reorientation of strategy toward a somewhat lower rate of output growth than the level of the first half of the 1980s.

Mr. Yamazaki made the following statement:

Due to the timely and appropriate policy response by the authorities since 1984, economic performance in Maldives has shown satisfactory development. Both fiscal and external deficits have declined sharply from their 1983 levels, and the ratio of external debt to GNP have also been steadily decreasing. Although economic activity in 1986 slowed unexpectedly, this does not seem to have caused a serious economic dislocation. Furthermore, the medium-term outlook seems to be favorable, partly owing to a judicious shift in the authorities' growth strategy to target a more moderate growth. For this approach, the authorities should be commended.

That having been said, however, some concerns remain. The size of the public sector in Maldives seems a little too large. Admittedly, in some developing countries, the public sector has to play an active and important role. However, total expenditure and net lending as a percentage of GDP is on the high side at 41 percent. Moreover, in the case of Maldives, the public sector has claimed a large portion of credit expansion, and it is apparent that the burden of the recent tight overall policy has fallen mostly on the private sector, contributing to a crowding out of this sector's activity. I believe an increased role for the private sector should be promoted in the coming years.

Considerable structural weakness persists in the external sector, posing major constraints on medium-term growth. Revenues from exports and services continue to be vulnerable to adverse developments in the external environment. International reserves representing only one month's imports are too small and should be raised. The labor market is tight, characterized by a shortage of skilled labor; it is therefore essential that the authorities take additional adjustment measures in those areas.

On fiscal policy, I feel somewhat uncomfortable to find that the budget is a little more expansionary in 1987. With a view to avoiding a crowding out of the public sector, expenditure should be kept to a reasonable level. In this connection, an increase in the wage bill should be minimized, while priorities in investment projects should be reassessed. Such policies should contribute to the restraint of overall expenditure. On the revenue side, tax receipts as a percentage of GDP are at the low level of 15 percent. I urge the authorities to broaden the revenue base and to strengthen the tax structure through the early introduction of a generalized sale tax or income tax.

On monetary policy, I welcome the authorities' tight stance. I also join the staff in welcoming the authorities' efforts to mobilize financial savings and increase the availability of credit to priority sectors in the outer atolls.

On the external side, the existence of a parallel market with a substantial premium in the past few years implies that the rufiyaa has been overvalued during the period and has exerted an adverse influence on external competitiveness, a matter of major concern to the authorities. I note with pleasure, therefore, that earlier in March, the authorities took decisive action to eliminate this parallel market, which has resulted in a substantial depreciation of the rufiyaa, as indicated in the supplement to the staff report. At the same time, the authorities removed the restriction on payments for current international transactions. The authorities are to be commended for these actions.

Finally, I would like to stress again that these adjustment measures should be accompanied by cautious financial and wage policies, and I urge the authorities to move in this direction.

Mr. Fox observed that since 1983, substantial progress had been made in reducing financial imbalances against a background of strong growth and falling inflation. Tighter fiscal policy had been an important element in that progress, combined with rapid development of the fishing and tourism sectors. On a related matter, while welcoming the ongoing review of the national accounts data, he would appreciate some assurance from the staff that the substantial overvaluation of the level of GDP reported in the staff paper did not affect the pattern of developments from year to year.

Unfortunately, Mr. Fox continued, developments in 1986 had been rather disappointing, and prospects for 1987 were mixed. The most serious problem was the budget deficit, which seemed again to be on the increase. While the authorities had acted to curtail the monetary and external effects of the increasing deficit, their efforts had been at the expense of the private sector, with implications for the pace of development.

Although the slowdown in growth in 1986 had been due primarily to external factors, the sharp contraction in credit to the private sector had also probably had some adverse effect. He would welcome staff comment on that point. Growth, which had experienced a setback in 1986, should rebound in 1987, and the current account deficit should be reduced somewhat. However, that should not encourage the authorities to delay the much needed reforms.

The adjustment in the fiscal deficit achieved between 1983 and 1985 was impressive, Mr. Fox commented. However, while government savings performance had improved somewhat over the period, most of the adjustment had been due to cutbacks in capital expenditure. Moreover, the improvement in public sector savings had been reversed in 1986 and, combined with a pickup in capital expenditures, had resulted in a more than doubling of the budget deficit. Those trends were expected to accelerate in 1987, although he noted that the staff expected capital expenditure to fall short of target once again. There would seem to be much to gain from more stability in public capital expenditure and more realistic planning to take account of the likely availability of external resources. The discussion in the staff paper of World Bank recommendations in that area had been useful, but he remained unclear about the assessment of the overall level of development spending and the Government's priorities. For example, he was interested in the authorities' intention to attach greater priority to investment in agriculture, which according to the introduction to the staff report was limited in potential because of the scarcity of arable land and the lack of interisland transportation. Staff comments on those points would be welcome.

The reduction in the share of current spending in GDP between 1983 and 1985 had been more than reversed in 1986, and he would urge the authorities to examine every avenue for effecting economies, Mr. Fox said. There appeared to be administrative constraints on increasing tax revenues, at least in the short term; against that background, expenditure would inevitably have to bear the burden of fiscal adjustment. And in the absence of economies in current spending, capital expenditure would once again bear the brunt of the adjustment.

Medium-term projections assumed a decline in the fiscal deficit to about 6 percent of GDP in 1988-91, Mr. Fox observed. Compared with the likely outturn in 1987--which the staff had estimated might be somewhat below 8 percent of GDP--the planned reduction, although a step in the right direction, would leave the deficit somewhat above the low point achieved in 1985, and he would therefore welcome staff comment on the pace of the adjustment effort.

Firm monetary control was undoubtedly needed, given the short-term budgetary outlook, to prevent monetization of the deficit adding to pressures on inflation and the balance of payments, Mr. Fox remarked. However, the system of monetary and credit control needed overhauling to promote a more efficient allocation of resources and, in particular, to prevent crowding out by the public sector of important development expenditures. Since the introduction of the credit/deposit ratios for commercial bank lending to the private sector, such lending had fallen sharply, while credit to the Government had continued to rise rapidly. Not only was credit to the Government unaffected by those controls; much of it was at highly subsidized rates. He strongly urged the authorities to introduce marketable financing instruments as a means of satisfying their borrowing needs and ending the discrimination against lending to the private sector inherent in the current system. The authorities should seriously consider the staff's recommendation to replace the current system by more effective use of reserve requirements. Indeed, he would be interested in knowing why the authorities had chosen to introduce credit/deposit ratios rather than making use of the existing reserve requirement system.

External policies also needed rationalizing, Mr. Fox considered. The need for tighter import licensing was presumably not unrelated to the overvaluation of the official exchange rate; and both those elements were seen to have hampered development, particularly the growth of exports. However, as reported in the supplement to the staff report, a devaluation had taken place, and the parallel foreign exchange market had been eliminated. Against that background, it was interesting that the authorities had chosen to revise downward their ambitions for growth in the medium term, despite what was in some ways--including the reduction in oil prices and the lower exchange rate--a more favorable external environment. Of course, it might well be that such a downward revision had been necessary in order to produce a more sustainable picture. It might also be that the authorities felt that they could achieve growth closer to the experience of the past few years into the medium term--and to combine that growth with a stronger external sector--if they introduced further changes along the lines recommended by the staff. The exchange rate was undoubtedly realistic at present, but a simplification of the system of import licensing--if not a complete abolition of licensing--was required, together with a more market-related system of credit controls and structural policies, for example, to alleviate shortages of skilled labor. Moreover, it was important if the devaluation was to be successful that it be combined with restrained financial policies. In that regard, he noted from the supplementary paper that the 1987 fiscal deficit was currently estimated to be significantly smaller than the budget estimate. Staff clarification of how that compared with the estimates of an unchanged deficit in 1987--as reported in the main staff report--would be welcome.

Finally, on the consultation cycle, Mr. Fox said that his chair could go along with a move to a two-year cycle, with staff visits in alternate years, assuming such a schedule was acceptable to the authorities. However, he remained open-minded about what in the longer term should be the appropriate consultation cycle for Maldives once the staff had had a chance to review the cycles of all members in light of the Board's recent discussion on the implementation of surveillance.

Ms. Lundsager made the following statement:

This year's consultation shows a marked improvement in the medium-term prospects for Maldives economy, due in large part to a reorientation of the basic policy stance of the authorities. We welcome this change in outlook, especially in light of the concerns we raised in 1986 about the sustainability of the very high growth rates. It now appears that a more modest growth rate will be targeted, but that target appears to be more consistent with the welcome decline in the relative debt burden and the expected concessional capital inflows.

The recently implemented exchange market reforms reported in the supplementary paper are particularly welcome, since they have led to the disappearance of the parallel market. The sizable depreciation that occurred could, along with continued flexibility over the next few years, encourage export diversification and assist the authorities in attaining their economic growth goals. In another area, however, we are somewhat disappointed to see the growing scope of economic activity controlled by the public sector, with ratios of both revenues and expenditures to GDP increasing over the past years. The authorities apparently share some of these concerns and are considering a modest decline in those ratios next year. We would suggest, however, that more ambitious targets for deficit reduction and expenditure control be considered, and we would be interested in hearing staff views on the scope for savings on current expenditures. Let me add that the reductions planned in capital expenditures appear appropriate, in light of the very high budgeted levels in the past that frequently were not attained. The described reorientation of the investment budget toward the more productive sectors seem sensible as well.

On monetary policy, it would make sense to support the productive sectors by provision of adequate credit, although many existing entities are able to draw on external resources to finance operations. We wonder to what extent this is adding to external debt The staff report contains data on just public sector debt, and we would appreciate any informal indications the staff might have on the scope of private sector debt. In addition, we share the staff views on the usefulness of modernizing monetary policy tools and broadening the financial sector to mobilize domestic savings.

Finally, we would be interested in staff comment on the role of foreign investment over the medium term. There appear to be few restrictions, and we wonder whether a better performance for foreign investment than indicated in the medium-term outlook might not be possible. In general, the outlook for Maldives is much improved, and the authorities appear to be embarking on a more sustainable medium-term adjustment path. We support this direction and thus feel comfortable with the proposed 24-month cycle, especially in light of the recent exchange market reforms.

Mr. Vasudevan made the following statement:

We are broadly in agreement with the staff appraisal. Mr. Alhaimus's helpful statement has demonstrated that the economic situation of 1986 was essentially a reflection of the working of adverse exogenous factors, with prospects for 1987 showing considerable improvement. Although GDP growth decelerated sharply in 1986, the inflation rate was kept within reasonable limits by strong and restrictive monetary policy. Credit expansion to both the public and private sectors showed substantial declines. The balance of payments situation was satisfactory, with the current account deficit--which itself was narrow--more than offset by a surplus on the capital account. The budget deficit, however, increased, reflecting larger capital expenditures. While capital expenditures in 1986 were higher than those in the previous three years, the outcome apparently was facilitated by foreign loan disbursements for some of the important projects, such as the Fisheries Phase II project, and the airport development and commercial harbor projects as shown on page 22 of the background paper. As such, the effects of the increases in capital expenditures might not be altogether adverse; in fact, it could be argued that the increases have tended to create a base for an improvement in the production potential.

The outlook for 1987 appears to be favorable, and it is important to note that the fiscal deficit is likely to be no larger than in the previous year. Given the limited implementation capacity, capital expenditures are expected to come up short of target, as the staff has suggested. The external payments situation appears to be manageable, with the services sector likely to give rise to additional receipts, mainly due to expected larger tourist arrivals. In the medium term, the baseline scenario provided by the staff appears feasible, particularly since the exchange rate has been allowed to float from March 1, 1987, which should improve external competitiveness. We suppose this factor was not taken into account at the time the medium-term outlook was prepared. The latest developments should provide additional impetus to exports; and if this is considered, the medium-term outlook will appear brighter. On a matter of clarification, I note that the staff has stated that the outlook projection has been revised since the previous projection for a variety of reasons, one of them being a reduction in the income elasticity of imports. We wonder about the extent of the reduction in their elasticity and whether the staff would expect the assumed elasticity to continue through the medium term, in view of the latest measures in the area of the exchange rate and payments.

Appendix Table 23 of the background paper shows that the banks' credit-deposit ratios could pose a problem in the future unless some measures are taken to keep credit expansion in check and to raise deposits. I am not certain whether any review of the present monetary instruments would help take care of any problem that might arise due to increasing credit-deposit ratios, and it is possible that I am attaching more importance to this information than is warranted. I would be grateful for any reaction the staff might have to this issue. Finally, we have no difficulty with the proposed consultation cycle, so long as it is acceptable to the authorities.

Mr. Ouanes made the following statement:

Notwithstanding the obvious limitation on resources and Maldives's vulnerability, as described in Mr. Alhaimus's helpful statement, the Maldivian economy has managed to grow at a rate in excess of 10 percent over the past several years. In 1986, despite a setback in growth, some real improvements were registered: real growth remained robust; the total external debt was reduced; and the overall balance of payments registered a modest surplus. What is encouraging is that the prospects for 1987 and beyond are good, with real economic growth expected to recover to a high in the range of 7-8 percent, and with the balance of payments situation being essentially sustainable in the medium term.

I find appropriate the authorities' outward-oriented development strategy based on fishing, tourism, and garment industries. Further, given the limited absorptive capacity and the tight labor market, I welcome the recent shift in policies toward the achievement of a lower, but more sustainable, growth objective than in the early 1980s. I am also encouraged by the authorities' most recent action in the exchange rate area. The adoption of a floating exchange rate system and the removal of foreign exchange financing requirements for the issuance of import licenses are commendable, and if they are supported by more restrained financial policies, they will contribute substantially to improving Maldives's international competitiveness. In that regard, I am concerned about the continued tightness of labor market and its impact on competitiveness. This is an area where the authorities need to be particularly vigilant. I therefore urge them to strengthen the fiscal position and to be selective in initiating investment projects so as not to tax the country's absorptive capacity and contribute to upward pressures on the labor market. These two measures, in connection with the shift in growth strategy and improved monetary control should help to ease pressures on wages. For the longer term, the authorities should continue their efforts to train and improve the skills of the available work force. This will not only improve the supply of labor; it will also enhance the domestic content of the county's exports.

In conclusion, although the revised medium-term outlook appears to be more sustainable than earlier expected, the authorities should continue their cautious policies in order to consolidate the recent gains achieved in economic adjustment and to further improve the prospects for the balance of payments. The recent commendable adjustment in the authorities' policies is clearly witness to their flexibility and pragmatism. I wish the authorities well and support the proposed decisions.

The staff representative from the Asian Department observed that growth potential in Maldives was hampered by a shortage of the supply of labor. Faster growth would require an increase in foreign experts, which, from a balance of payments viewpoint, meant greater remittances. In that sense, it was not easy to maintain a high growth strategy without solving the labor shortage bottleneck. Also for that reason, the recent devaluation and the adoption of a floating exchange rate system should help private investment, particularly in tourist-related activities. On a technical point relating to the national accounts, he noted that major revisions had been effected on the value-added side of the accounts--as opposed to the expenditure side--in the valuation of fish catch and government services as well as some construction activities.

In reply to questions on the implications of recent adjustment measures for monetary policy, the staff representative explained that the authorities had made use of tight credit policy rather than other instruments because, at the time, they had seen no reasonable alternative. They could not have resorted to a floating exchange rate system or a devaluation and could not have forgone expenditure cuts. Hence, the main burden of adjustment had fallen on credit policy for the private sector. One Director had wondered whether the staff had not attached too much importance to financial instruments. As he understood it, the authorities were interested in issuing treasury bills not so much to finance the budget deficit as to develop the financial markets so that open market operations could be facilitated in future and overall reserve requirements could be used more effectively.

On the fiscal side, it was expected that capital expenditure would fall short of the amount envisaged in the initial budget, the staff representative continued. Moreover, because of the recent devaluation, the staff was expecting revenue from customs to increase substantially. Provided that the authorities did not increase the wage bill, the overall deficit in 1987 should be smaller than that in 1986. Based on past practice, he would expect the authorities to stick to their wage bill controls; of course, other current expenditures would need to be increased as prices were adjusted under the new floating exchange rate system.

Externally, the overall balance of payments position should improve substantially, the staff representative considered. According to preliminary calculations, the real effective exchange rate should depreciate by approximately 10 percent by the end of the year. Because Maldives was a small, open economy, it was assumed that most of the adjustment following the adoption of the floating exchange rate system was due to the supply response. Given the very limited scope for investment activity to pick up in the short run--and considering the various administrative constraints--the supply response should be small. Over the medium term, however, the staff had allowed for greater elasticity of supply in response to price changes. Most of the improvement would take place in the export of fish and in the growth of resort facilities; as a result, the current account deficit should be somewhat less than half of what had earlier been projected for 1991. On external debt, the private sector had no obligation to report debt statistics to the authorities, and the authorities had made no effort to collect any information on external debt. Finally, he could assure Mr. Fox that the authorities were agreeable to the 24-month consultation cycle. They had also requested that the staff visit the country annually to exchange views, and he fully expected the authorities to adopt the recommended measures, once they were convinced of the need for doing so.

Mr. Alhaimus observed that the fiscal situation in Maldives was largely influenced by expectations of foreign inflows. Large expenditures were often effected on such expectations, which might give the impression that there was a deliberate policy to expand the public sector at the expense of the private sector. However, he saw no evidence of any attempt through policy in Maldives to limit the private sector. The opportunities for private sector investment in Maldives were limited, but the authorities were doing their best to expand them.

He did not believe that current expenditures in Maldives had been excessive, Mr. Alhaimus continued. The increase in expenditures on wages in 1986, for example, had not been due so much to a rise in salaries--which had remained practically unchanged since 1983--as to the filling of vacancies that had remained unfilled in the previous period, when the manpower shortage had been more intense. Furthermore, some very necessary expenditures had been made on defense to rejuvenate an aging fleet. In general, therefore, current expenditures had been reasonable. For 1987, moreover, there should be no cause for concern. The expenditures in the budget were mainly capital expenditures; and experience suggested that actual expenditures would not be as high as budgeted. In that respect, the fiscal deficit for 1987 as a percentage of GDP would be lower than that in 1986. Over the medium term, the deficit was expected to be about 6-7 percent of GDP, which was not unsustainable.

The main issue in the area of monetary policy was credit control, Mr. Alhaimus considered. Originally, the intention of the authorities was to alleviate the strong demand for foreign exchange, which had been unsustainable. The authorities at the time had found credit control to be the only viable means of fulfilling their intention, since alternative methods could have created serious problems. Fiscal expenditure was not easy to constrain at the expense of development needs, and the authorities had ruled out use of the exchange rate on the fear of inflationary repercussions. That fear was quite real, in his view. A scenario prepared by the staff during the consultation discussions assumed a depreciation of 20 percent and, on that basis, a doubling of the rate of inflation. Given that danger, the authorities had been reluctant to make an exchange rate adjustment. The authorities were aware of the impact on private sector activity of credit controls and were taking steps to ensure that legitimate credit requirements would be met. They were also reviewing the credit situation in practically every quarter and had determined that, on the whole, the credit policy had been successful in helping the external balance in 1986. The authorities intended to maintain the credit policy until major adjustment measures were taken elsewhere in the economy. In that respect, they had recently adjusted the exchange rate, but they would no doubt need time to assess the situation before taking any action with respect to credit policy.

Finally, the other problem that was raised in the discussion was the labor shortage, Mr. Alhaimus remarked. That was a real problem, and the authorities had taken several steps to alleviate the shortage through training activities, but they were also looking for new sources of labor. Of course, the lower growth strategy over the medium term should contribute to the alleviation of the problem.

The Acting Chairman made the following summing up:

> Executive Directors observed that following several years of rapid expansion, the pace of economic growth slowed in 1986, largely as a result of exogenous factors. Welcoming a further improvement in the overall balance of payments and in the external debt profile, and taking note of the more favorable economic outlook for 1987, Directors nonetheless stressed the importance of continued adjustment efforts to strengthen the external payments position, particularly in view of the extremely low level of international reserves, the tight labor market, the vulnerability of the economy to adverse external developments, the still high level of external debt, and the need for export diversification. They welcomed the authorities' intention to pursue a more moderate and sustainable growth strategy over the medium term. In this context, they encouraged the authorities to strengthen labor training programs in order to alleviate the labor shortages.
>
> Directors expressed concern at the weakening of fiscal restraint in 1986, following two consecutive years of improvement, and at the expansionary stance envisaged in the 1987 budget. In view of the importance of fiscal restraint for external adjustment, they urged the authorities to adopt a more ambitious goal for the reduction of the public sector deficit, through restraint in current expenditures (particularly the wage bill) and through a careful review of the priorities of the investment program, consistent with the country's absorptive capacity and the availability of foreign assistance. It was also emphasized that a cautious expenditure policy should be supported by efforts to broaden the revenue base by introducing a generalized sales tax or income tax.

A marked slowdown in credit expansion under a continued tight credit policy in 1986 contributed to the improved external payments position. At the same time, the burden of the slowdown in credit expansion fell entirely on the private sector. It was stressed that, in order to avoid a crowding out of private sector activity in the future, the burden of the credit policy should be shared by the public sector as well, mainly through a reduction in government borrowing from the banking system. Directors also encouraged the authorities to explore alternative means for a more indirect control of monetary aggregates, including the introduction of marketable financial instruments.

Directors noted with satisfaction the authorities' progress in rationalizing the tariff system and urged the authorities to move rapidly toward a more general import licensing system. They welcomed the authorities' recent action to remove the restrictions on payments for current international transactions and to adopt a floating exchange rate system, action which has resulted in both a substantial adjustment in the exchange rate and the elimination of the parallel market. They remarked that this system, together with prudent financial policies, should contribute substantially to improving Maldives's external competitiveness and payments position over the medium term.

It is expected that the next Article IV consultation with Maldives will take place on a 24-month cycle, with an intervening staff visit, after which a brief report will be circulated to the Executive Board.

3. WESTERN SAMOA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Western Samoa (SM/87/44, 2/17/87; Cor. 1, 3/6/87; and Sup. 1, 3/6/87). They also had before them a background paper on recent economic developments in Western Samoa (SM/87/46, 2/20/87).

Mr. Rye made the following statement:

My authorities would like to thank the staff team for the comprehensive report on the economy of Western Samoa. For small island economies like this a Fund mission and its appraisal provide a unique opportunity for the authorities to consider trends and strategies in a comprehensive and constructive way. Western Samoa has appreciated such dialogue with the Fund both generally and with this particular mission.

My authorities are in broad agreement with the thrust of the staff appraisal. They would like to stress a few points of historical development and remark on future policies.

In examining Western Samoa's economic history two trends stand out: first, the sluggish economic performance through the 1960s and 1970s; and, second, the much improved position in the latter part of the 1980s. The year 1983 marked a watershed in Western Samoa's economic management. In that year, the authorities embarked on a structural adjustment program with the assistance of two Fund stand-by arrangements. The structural measures were orthodox and coherent. They included improving the budgetary position, tightening money and credit, improving the performance of public enterprises, liberalizing external trade and payments, and adopting a more flexible exchange rate policy.

The measures have worked and are working. Western Samoa is now looking at annual growth prospects of 2-3 percent, whereas in the previous two decades average annual growth was somewhat less than 1 percent. Economic activity still remains rather narrowly based, with copra and copra products accounting for 60 percent of exports, but diversification efforts are starting to pay off, especially in the area of tourism. Remittances from overseas will continue to provide an essential contribution to Western Samoa's balance of payments.

Despite a sharp drop in export copra prices, 1986 was a year of further economic progress and consolidation. Growth was about 1.5 percent, consumer price rises declined to 7 percent, and there was a fiscal surplus of 3 1/2 percent of GDP. My authorities recognize that public sector wage and salary payments expanded too rapidly in 1986. They have moved to restrict the 1987 wage rise to 3 percent and have imposed a freeze on new positions. On the external side, the current account deficit declined to 8 percent of GDP, and international reserves increased to cover five months of imports.

The Government is determined to continue cautious financial policies, to achieve a greater rate of domestic savings, and to provide adequate price incentives--through appropriate exchange rate and tax policies--for investment and production. The authorities intend to step up efforts to improve domestic revenue mobilization. In this connection, they are carrying out an overall review of the recent and proposed tax changes. On February 18, the Cabinet appointed a special commission to review the income tax reform, the extension of the goods and services tax, and customs tariff rates. The Fund has recently agreed to provide technical assistance for this tax review, and my authorities are very appreciative of this support.

The Government is also intensifying its efforts toward the privatization and rationalization of public enterprises. In January 1987 the Government began a joint exercise with the Asian Development Bank to formulate a medium-term program for improving the efficiency of public enterprises, including the privatization of selected government activities and public corporations. The Government is also planning to submit a bill to the new parliament to rationalize the marketing activities of major public enterprises in order to stimulate agricultural production. This substantial reform should bring about major efficiencies in the marketing of agricultural products.

In the area of monetary policy, with the recent introduction and implementation of a more dynamic credit arrangement, the authorities plan to continue their vigilant watch on credit developments in the period ahead. They are prepared to introduce additional measures if credit growth presents any threat to price stability and the balance of payments. They will also continue to maintain their cautious interest rate policy to mobilize financial savings for productive investment.

On the external front, notwithstanding their achievement in lowering external debt and eliminating payments arrears, they plan to improve the debt management system in the period ahead.

My authorities would like to thank the Fund for the technical assistance and training programs provided to Western Samoa. Because of shortages of trained manpower, they highly value the advice given by both the Fund staff and members of the panel of experts serving in Western Samoa. They wish also to put on record that, in light of the structural weakness in the balance of payments, Western Samoa is interested in using the resources available under the structural adjustment facility.

Mr. Yamazaki made the following statement:

Due to continuously applied comprehensive economic adjustments, Western Samoa's economy has registered quite satisfactory development in 1986. Although real GDP growth is still on the low side, the inflation rate has fallen to its lowest level in many years. The fiscal budget recorded a surplus, and the current account deficit declined further, partly due to the curtailment of import payments induced by judicious financial restraint. The ratio of external debt to GDP and the debt service ratio have also been declining. Most of the credit for these favorable outcomes should be given to the authorities, and I highly commend them for their effective implementation of adjustment measures.

Despite this progress, however, structural weaknesses remain, especially in the external area. External debt is still on the high side, and the external position is relatively vulnerable to the external environment, because external receipts depend heavily on the export of copra, workers' remittances, and foreign grants.

In this connection, the authorities should strongly pursue economic diversification in the medium term by encouraging adequate price incentives for investment and production in the private sector.

Now that Western Samoa's economic situation is relatively stable, I can support the authorities' intention to pursue a more accelerating economic growth target. However, as Western Samoa is a small economy with structural weaknesses, its economic development should be closely monitored, and its growth should be gradual. With a view to avoiding large fiscal and external imbalances, emphasis should be placed on the exercise of cautious financial policy.

As I am in broad agreement with the staff appraisal, my remarks on specific policy areas can be brief. First, on fiscal policy, given the positive impact of the fiscal surplus on the financial and external areas in 1986, expenditures should continue to be kept under tight control. Hence, I welcome the effort to restrain the growth of the wage bill. Further nationalization and privatization of public enterprises is also welcome. On the revenue side, because scope for expansionary fiscal policy remains rather limited, the tax system, together with an active exchange rate policy, may have to play a vital role in providing production and investment incentives. Therefore, I am looking forward to the results of the forthcoming comprehensive review of recent and proposed tax changes.

Second, monetary policy should play a central role in encouraging a sound fiscal and external position under a more accelerating growth target. I therefore agree with the staff that a cautious monetary policy stance should be maintained. I also join the staff in welcoming the recent measures adopted by the authorities to promote competition and to foster the growth of banking activities.

Third, it is clear that recent exchange rate movements have already contributed to a strong external position in Western Samoa. Taking into account the remaining weakness in the current account structure as noted above, however, it seems clear that a more flexible exchange rate policy should be pursued over the medium term. Further, given the relatively large size of the external debt in relation to GDP, the authorities should make further efforts in the debt management area. In this context, recent rapidly increasing external borrowing by private enterprises should be carefully monitored. Finally, I can support the proposed decision.

Mr. Woodward, commending the authorities for maintaining their adjustment efforts in 1986, thereby offsetting the negative effects of a serious decline in the terms of trade, observed that the results of the authorities' efforts had been encouraging. The fiscal position had been strengthened further--although not as much as originally intended, excluding grants; both the current account deficit and the inflation rate had been further reduced; and international reserves had been boosted substantially. While the growth rate had fallen slightly, the decline had been less than one might have expected in an open economy facing a largely unexpected drop of nearly one third in the terms of trade.

Over the longer term, diversification of the Western Samoan economy would clearly be important, particularly in the export sector, and the authorities' intention to step up efforts in that area was welcome, Mr. Woodward continued. However, 1986 had not been a good year for export diversification. Exports of timber and beer had declined sharply for the second consecutive year; exports of fruit juice and "other exports" in Table 21 of the background paper had also fallen sharply; and tourist arrivals had stagnated. Comments from the staff on the causes of those developments and on the prospects for recovery in those sectors would be welcome. In particular, he wondered whether a further devaluation might be needed and whether the reduction in public sector investment in 1986 was likely to have a negative impact on diversification.

Remarking on more immediate policy concerns, Mr. Woodward indicated that he shared the staff's misgivings that the tax reductions in anticipation of the proposed extension of the goods and services tax might be premature. He was also concerned that the extension itself might impose some strain on tax administration. The proposed comprehensive review of tax changes was thus welcome, as were the recent changes in credit control--which should allow greater flexibility while limiting the risk of excessive credit expansion--and the authorities' intention to maintain a cautious monetary policy in 1987. In conclusion, he wished the authorities well in their efforts to diversify the economy and increase growth, and he expressed the hope that the achievement of those objectives would be supported by structural adjustment facility resources at a later date.

Mrs. Walker made the following statement:

> Western Samoa has made considerable progress since 1983 under two Fund programs followed by the authorities' continued pursuit of economic adjustment measures. Economic developments in 1986 on the whole were quite positive, in spite of a sharp drop in the international price of copra. The staff projects the economic outlook for 1987 to be a continuation of current trends for output growth and inflation, as well as a firming of export prices. However, it appears that the faster output growth will put some pressure on the balance of payments, and there is still some uncertainty in the medium-term economic outlook, due to structural weaknesses in the economy.

While understanding the authorities' desire to encourage more rapid economic growth over the next few years, we welcome the fact that they are determined to pursue at the same time commensurately strong policy efforts in the areas of fiscal policy, financing of investment, and maintenance of appropriate price incentives for investment and production.

On the fiscal side, the substantial wage increases of the past are a concern, and I therefore welcome the authorities' move to restrict the wage rise in 1987 to 3 percent and to impose a freeze on new positions. It is also encouraging that the 1987 budget aims to reduce expenditure on covering losses of the public enterprises through the rationalization and privatization measures. However, we agree with the staff that financial management of public sector enterprises needs to be improved further, and we thus welcome the joint exercise between Western Samoa and the Asian Development Bank to formulate a medium-term program for improving the efficiency of public enterprises.

The tax relief package included in the 1987 budget appears to contain some measures--such as the reduction in corporate and individual income tax rates--that could provide incentives for production. However, we agree with others that further study on the overall tax system should be undertaken, and we thus welcome the fact that the Fund will provide technical assistance in this area.

With regard to monetary policy, I note that there will be a need for increased credit to the private sector as its role increases in productive activity. The staff comments in its appraisal that in light of this increase in lending to the private sector, regulatory and monitoring arrangements will need to be strengthened. Staff elaboration on these arrangements would be helpful.

We can agree with the authorities' medium-term policy strategy, which stresses economic diversification through increased private sector activities. While the copra industry will undoubtedly remain a large part of export activity in the country for some time, it will clearly not be able to provide by itself the sought-for, export-led growth in future, and diversification will thus be important. In this regard, I wonder whether the staff could provide a more detailed explanation of what measures the authorities plan to undertake to promote private sector activities in noncopra crops and in the nonagricultural sectors, especially tourism.

Noting that the authorities intend to continue their gradual exchange rate adjustment, we believe they should be open to using the exchange rate policy in a flexible manner to promote diversification efforts through increased private sector activity.

We also welcome the cautious external borrowing policy pursued by the authorities, but we note that the staff believes that short-term trade credits need strengthened monitoring.

Finally, I wish to comment on the proposed 12-month consultation cycle. Certainly, if the authorities were to adopt a structural adjustment facility arrangement, the 12-month cycle would remain appropriate. However, if they were not to adopt such an arrangement, there might be scope for moving Western Samoa to an interim cycle of the sort discussed recently in the context of the surveillance review. Although past improvements in the economy were assisted by Fund involvement, and although there is some uncertainty with regard to the medium-term outlook, Western Samoa's economy is performing fairly well, and the authorities are following economic policies designed to move the economy further in this direction. I would be interested in comments from the staff or Mr. Rye on the possibility of moving Western Samoa to a longer cycle.

The staff representative from the Asian Department noted that non-copra exports in 1986 had stagnated mainly for technical reasons related in part to production line changes. In the beer industry, an effort had been made to expand capacity; as a result, operations had slowed temporarily, but the implication was that exports would recover in 1987. In the tourism sector, progress had been somewhat disappointing, although the numbers were a reflection of two important factors. First, a very sharp jump in tourism had occurred in 1985, making the 1986 numbers appear less positive; second, problems with the data made it difficult to distinguish between tourist receipts and remittances receipts, and it was possible that tourism receipts for 1986 had been underestimated.

In response to questions on private investment, the staff representative observed that the longer-term trend was toward a faster increase in investment. However, whether the diversification efforts being undertaken by the authorities would translate into an immediate acceleration in investment growth in 1987 was doubtful, especially since the diversification process itself was relatively slow. On the nature of the measures being taken to promote private investment, it was the staff's understanding that the authorities' strategy was to provide an environment conducive to improved private sector activity, particularly investment. Such an environment would include, most importantly, relative prices that would encourage investment.

Remarking on the regulatory and monitoring arrangements for private credit extended by the domestic banking system, the staff representative observed that at the beginning of 1987, the authorities had implemented an innovative set of measures, including termination of credit ceilings on which Western Samoa had relied for several years. The system of credit ceilings had been replaced by a system that linked credit growth to the growth of deposits. While such measures had been introduced only after careful examination, and while an effort had been made to ensure that the instruments were consistent with the authorities' policy targets, the instruments were new, and the unexpected could happen. That was why the staff had stressed the importance of careful monitoring of monetary developments with the introduction of additional measures if necessary. In that respect, consideration was being given to the possible reintroduction of credit ceilings if credit growth became excessive. In the context of the Western Samoan economy, the most powerful instrument used extensively by the authorities was the direct instruction to commercial banks regarding their credit ceilings.

Finally, on the consultation cycle, the staff representative recalled that when the matter had been discussed in November 1986, the authorities had indicated their desire to remain on a 12-month cycle at least for the next consultation. Their request was supportable in light of the major policy changes they were undertaking, the uncertainties for the economic outlook in the medium term, and the close working relationship between the authorities and the Fund staff over the years.

Mr. Rye observed that the projections in the latest staff report differed significantly from those in the previous report. In 1986, for example, the projection for economic growth in the late 1980s through 1990 had been approximately 2 percent a year, while in the latest report the projection was for a 3-3.5 percent growth rate. Similarly, inflation, which had earlier been projected between 6 percent and 10 percent in the second half of the 1980s, was currently projected at 5 percent; and export growth, earlier expected to be about 5-6 percent in the late 1980s, was currently projected at 20 percent. The point of making such comparisons was to give substance to his view that the Executive Board tended to overrate such projections and to give more weight to them than they deserved. It was unclear whether the latest projections were any more likely to turn out to be well founded than those projected in the previous year. Certainly, it should be stressed that, while the authorities had thought that the 1986 projections were pessimistic, they were by no means overjoyed with the more recent projections. In his recent budget statement, the Finance Minister had noted that although the authorities had achieved some success in controlling inflation, developments in other economic indicators had not been favorable; and he had pointed out that the underlying factors in, and prospects for, the balance of payments remained disquieting. He had set those remarks in a longer-term context and had noted that, over time, the authorities had found it necessary to go out of their way to obtain extra quotas for Samoans to emigrate because of "insufficient natural resources and economic opportunities for everyone in our country."

He supported the staff's view that, for the time being at least, it would be preferable to hold to the 12-month consultation cycle, Mr. Rye continued. If the burst of policy developments under way at present began to slow, and if the short- and medium-term economic picture were to become less clouded, the question of the consultation cycle could be reviewed; it might even be appropriate to undertake such a review on the occasion of the next consultation.

The Acting Chairman made the following summing up:

Executive Directors noted that Western Samoa achieved further progress in implementing growth-oriented stabilization policies in 1986. Inflation moderated further and, despite sharply lower prices for the country's principal export, the external payments position improved. This progress was due in large part to the authorities' financial restraint. At the same time, Directors observed, the economic structure remained weak. Directors therefore supported the authorities' plan to accelerate growth by further diversifying output and exports through increased private sector activities and by strengthening the copra and public enterprise sectors. They shared the authorities' view that the acceleration of growth should be gradual in order to safeguard the progress already achieved in economic stabilization.

Directors commended the authorities for pursuing cautious financial policies that contained the expansion of budgetary expenditure and bank credit in the last few years. They observed that the budget and monetary program for 1987 embodies this cautious stance even as the overall policy emphasis is shifting toward promoting growth. They emphasized that a continuation of these cautious financial policies, combined with substantial efforts to mobilize higher domestic savings, maintain adequate price incentives, and restrain wages, would be essential in sustaining faster growth over the medium term.

In the budgetary area, Directors stressed that efforts should be intensified to strengthen expenditure control and enhance revenue mobilization. Priority should be given to rationalizing the management and operation of public enterprises, strict restraint on public sector employment, and strengthening the tax system so as to reduce dependence on external grants. In particular, Directors noted the importance of conducting a comprehensive tax review with a view to establishing a system that, inter alia, would increase revenues and provide appropriate incentives for domestic investment and production. They welcomed the collaboration between Western Samoa and the Asian Development Bank to formulate a medium-term program for improving the efficiency of public enterprises, including the privatization of selected corporations and reform of the marketing of agricultural products.

Directors considered that the recent replacement of credit ceilings with an arrangement that links additional credit to the growth of long-term deposits would facilitate more dynamic growth of banking activities. They welcomed the effective tightening of the liquidity requirement for commercial banks, which would improve credit allocation and enhance the Central Bank's control over domestic credit and liquidity.

Directors observed that a successful achievement of faster growth would be facilitated by the maintenance of adequate price incentives. In particular, they stressed that an active exchange rate policy would contribute importantly to stimulating investment and production and improving the allocation and use of resources. They considered such a policy would be especially important to the authorities' strategy for economic diversification through increased private sector activities.

The authorities were commended for their success in reducing external debt. Directors also noted the importance of improving the debt management system, particularly in view of the likely increase in borrowing by private enterprises.

The recent termination of the advance deposit requirement for certain imports was welcomed, and the authorities were encouraged to further liberalize the external trade and payments system.

Directors noted the authorities' interest in the Fund's structural adjustment facility (SAF) and expressed the view that further structural adjustment measures would be appropriate as part of any SAF program.

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

The Executive Board then took the following decision:

1. The Fund takes this decision in concluding the 1986 Article XIV consultation with Western Samoa, in the light of the 1986 Article IV consultation with Western Samoa conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Western Samoa continues to maintain restrictions on payments and transfers for current international transactions in accordance with Article XIV as described in SM/87/46.

Decision No. 8548-(87/42), adopted
March 9, 1987

4. ST. LUCIA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with St. Lucia (SM/87/34, 2/10/87). They also had before them a background paper on recent economic developments in St. Lucia (SM/87/41, 2/19/87).

Mr. McCormack made the following statement:

St. Lucia's economic performance in recent years has been highly encouraging and, barring adverse exogenous developments, the island seems set on a course of steady advance. This optimistic assessment can be supported by reference to four main indicators.

(i) Real GDP growth has been accelerating since 1982, and for the last two years has averaged over 6 percent a year. The main sources of growth have been agriculture and tourism, with construction increasingly playing a positive role.

(ii) Inflation, which in the early 1980s was running at a rate in excess of 17 percent, has declined to some 2 percent in 1986. In 1987, only a fractional increase is expected.

(iii) The current account of the balance of payments in 1986 was equivalent to some 6 percent of GDP. Only four years earlier, the deficit had reached the dangerously high level of 27 percent of GDP. The overall balance of payments position is even more comfortable, with an overall surplus of 2 1/2 percent of GDP recorded in 1986. The medium-term outlook is also encouraging.

(iv) Unemployment remains at a disturbingly high level of close to 20 percent of the labor force. However, with the strong recovery in economic activity, there appears to have been some decline in unemployment levels.

My St. Lucia authorities do not see these trends as providing grounds for complacency. They recognize, in particular, that in the banana industry, present price levels and production volumes are exceptional. They view the current favorable conjuncture as providing an opportunity to consolidate progress on a number of fronts, particularly in relation to fiscal policy.

Since 1982, there has been a steady improvement in St. Lucia's public finances. Public sector saving, having been negligible in the early 1980s, had risen steadily in recent years; by 1986, public sector saving exceeded 7 percent of GDP and is expected to increase further in 1987. As the staff points out, these figures may be somewhat inflated because delays in negotiating a new public sector wage agreement have resulted in current expenditure being artifically dampened.

On the revenue side, there has been considerable progress in improving collections. The Inland Revenue Department, which had been lax, is undergoing a thorough reorganization, with USAID assistance, and this is likely to result in quite considerable revenue enhancement over the medium term. In the relatively near term, revenue is also expected to increase substantially as a result of the planned increase in consumption tax rates. Introduction of these new rates wsa originally delayed for technical reasons. The authorities remain committed to their introduction but, realistically, are unlikely to do so until after St. Lucia's elections, which must take place before August 1987 but could well occur considerably in advance of this deadline.

At the time of the previos Article IV consultation, the Board urged the authorities to seek means for the orderly settlement of overdue obligations, a problem which had been growing in importance for a number of years. In 1986, the authorities began to make inroads on the accumulated stock of arrears and are committed to their complete elimination by the end of 1990. The authorities have been in communication with international institutions concerning arrears in contributions and are currently engaged in negotiations with the major bilateral creditors. The authorities have used the opportunity provided by the domestic banks' highly liquid condition to borrow in order to reduce arrears of suppliers' credits. More important than these specific items, the authorities intend to make explicit provisions in the forthcoming and subsequent budgets for the elimination of arrears.

A major element of the Board's concern at the time of the previous consultation was competitiveness. In particular, the exchange rate regime, namely, a fixed parity with the U.S. dollar, called for wage increases to be contained. The authorities accept the logic of this position. It is the authorities' firm intention to restrict severely wage increases under the current negotiations; the very low inflation rates prevailing justify efforts to achieve a settlement of the order of 5 percent, as discussed in the staff report. However, there are considerable short-term uncertainties in the lead-up to the election, and it will probably take some time for the pay situation to be clarified. Looking beyond the election, the authorities are interested in negotiating a tripartite arrangement, involving government, unions, and emloyees, which would cover pay, productivity, and employment.

The authorities remain committed to currrent exchange rate arrangements, namely, participation in the common currency arrangement of the Eastern Caribbean Central Bank. They value the discipline which this system imposes and are prepared to accept the domestic policy constraints this link requires.

Finally, on behalf of my authorities in St. Lucia, I should like to express appreciation for the extensive work done by the Fund mission in the course of the Article IV consultation. My authorities value the frank and helpful advice offered by the mission and look forward to a continuation of the friendly and constructive contacts which have always existed between St. Lucia and the Fund.

Extending his remarks, Mr. McCormack observed that over the weekend, the Government of St. Lucia had announced that elections would take place on Monday, April 6.

Mrs. Walker made the following statement:

St. Lucia has experienced real GDP growth, led by agriculture and tourism, of more than 6 percent over the past two years, and similar expansion is projected for 1987. As Mr. McCormack has stated, the authorities plan to take advantage of such favorable growth prospects to consolidate progress in a number of areas, and we support that approach.

Steady improvement has been registered in the fiscal position of the Central Government. Most notable has been the reduction in the accumulated stock of arrears. We welcome the authorities' recognition of the seriousness of their arrears problem and their determination to settle the arrears. However, the expectation that it will take until 1990 to fully clear these overdue obligations, particularly in the face of a budgetary surplus--at least in 1987--appears somewhat puzzling. In this regard, we would agree that some effort to speed up the settlement of the overdue financial obligations is desirable. I do note that, to a large extent, the improvement in the Government's fiscal position is due to the delay in concluding a new pay agreement and that prospects for the 1987 budget deficit rest somewhat on the conclusion of such an agreement. I welcome the authorities' determination to hold firm in any negotiated settlement, and I urge them to do all they can to keep any wage increase as low as possible, particularly since higher wages than in neighboring countries have adversely affected St. Lucia's competitiveness in the past.

Tax collections have increased in the past two years, and tax reform has been initiated, with reductions in income tax deductions. However, the planned increase in consumption taxes has been delayed, and the delay may continue. I would be interested in staff analysis of the effect of a further delay on the fiscal position in 1987.

Capital outlays financed by domestic resources increased substantially in 1986. While this was due in part to the local component of construction of a new office building, such expenditures were still quite high. I urge the authorities to reduce the amount of capital expenditure financed domestically and to encourage foreign investment in order to cover a larger part of these expenditures.

It is encouraging to note that the World Bank is in agreement with the current public sector investment plan. However, it appears that there is room for improvement in the integration of the current and capital budgets and in the strengthening of project-monitoring procedures, which we support.

The Government's development strategy appears to be well founded, particularly with respect to its reliance on foreign investors to expand tourist facilities. I note, however, that growth in the manufacturing sector has been hampered by regional trade restrictions, limited marketing techniques, and competition from the region. I wonder whether this might not argue for some analysis (in the papers on the CARICOM economies) of interregional problems in promoting foreign investment.

The medium-term balance of payments outlook shows a widening of the current account deficits from 6 percent in 1986 to 11 percent in 1987, largely on account of increased imports for public sector investment plans. While the overall balance of payments outlook appears somewhat more favorable, external competitiveness could be enhanced through moderation and wage policy and a stronger fiscal position. Finally, we urge the authorities to take this opportunity to consolidate their fiscal position and to continue with their development strategy.

Mr. Hospedales made the following statement:

We are in general agreement with the staff's analysis and appraisal as well as with Mr. McCormack's statement. Over the past four years, St. Lucia has made considerable progress toward reducing macroeconomic structural imbalances: economic activity has been buoyant; inflation has decelerated; the Government's financial position has improved; and unemployment, while still high, has been declining. Nonetheless, the current account of the balance of payments remains fragile, wage and salary increases continue to be on the high side, and a small amount of arrears to creditors has arisen.

We continue to support the Government's general economic strategy to orient economic policy to the promotion of domestic savings and to the expansion of those activities--agriculture, tourism, and manufacturers--which would improve the resilience of the economy. We view the strengthening of the current account balance through increases in national savings as essential, especially since it is to be associated with a continuing growth of investment, as envisaged in the public sector investment program. It should be stressed, however, that project monitoring procedures must be enhanced to avoid slippages in cost overruns and implementation.

The use of concessional foreign borrowing to finance something over 50 percent of the public sector investment program should be sustainable. The resulting buildup of domestic capital stock will contribute to the future debt servicing capability of St. Lucia. At present, St. Lucia's debt service is low and manageable, but the existence of arrears, modest as they are, is having an adverse impact on St. Lucia's creditworthiness. Every effort should be made to correct the situation. We support the initiative of the authorities to utilize domestic commercial bank credit to accelerate the reduction in outstanding arrears.

The authorities' emphasis on promoting corresponding increases in national savings from both public and private sources is, therefore, well directed. In recent years, there has been a rapid improvement in public sector savings, although the authorities should be aware that it may be difficult to rely only on the public sector as a source of a higher level of national savings. While government expenditure has been restrained, it remains subject to some upward pressure, as wages for 1987 have not yet been settled. We urge the authorities in the circumstances to continue their efforts to achieve a better control of expenditure if recourse to higher taxation is to be avoided. Indeed, the authorities should adhere to their commitment to limit the increase in wages and salaries in 1987 to no more than 5 percent, especially in the context of the need to keep the economy internationally competitive, and given the limited scope for an independent monetary and exchange rate policy stemming from membership in the East Caribbean Central Bank.

Private savings are also being strengthened, and we view the prevailing competitive interest rates as a necessary condition to attract and retain savings in the domestic financial system. Also, the newly adopted tax reform reducing marginal rates and the imposing consumption taxes are steps in the right direction. In general, St. Lucia's economic performance has been satisfactory, and policies are in place to sustain the economic transformation of the country.

Mr. Fox considered that developments in St. Lucia since the previous consultation had been encouraging. Most noteworthy was the improvement in the fiscal position due to the combination of better tax administration, discretionary tax increases, and expenditure constraint, all of which had enabled the authorities to begin reducing arrears.

Over the past 18 months the authorities had made a commendable adjustment effort, laying the groundwork for a relatively comfortable outlook, barring unforseen adverse developments, Mr. Fox continued. He had been encouraged by Mr. McCormack's indication that the authorities would not be misled by their progress into complacency but that they intended to press ahead, particularly in the area of fiscal policy.

The staff had highlighted two main issues in the fiscal area: the need to maintain wage restraint; and the importance of completing the tax reform by implementing the planned increases in consumption taxes. Projections showed that if both those needs were met, the fiscal position would continue to strengthen, allowing further progress in normalizing relations with external and domestic creditors. Given the exchange rate arrangements maintained by St. Lucia, fiscal policy must be the main instrument for the achievement of external goals; and within fiscal policy, wage policy was particularly important. The depreciation of the East Caribbean dollar since 1985 had offset most of the deterioration in competitiveness that had taken place in the period between 1980 and 1985. However, as Table 30 of the background paper showed, most of St. Lucia's close neighbors had, for the same reason, witnessed an improvement in competitiveness at least as great as St. Lucia's. While the Caribbean as a whole was thus likely to increase its share of the world tourism market, how that increase would be parceled out as between individual islands would depend very much on the level and development of wage costs in each island vis-à-vis neighboring countries. The statement in the staff report that tourist facilities in St. Lucia were currently close to capacity offered some encouragement that St. Lucia was already competitive, but he would have welcomed some further discussion on that point by the staff, particularly given the buoyant projections for tourism and concerns about the importance of strengthening regional surveillance, which he and Mrs. Walker had mentioned during the previous week's discussion on surveillance.

On wage policy in particular, Mr. Fox observed that real wages in St. Lucia had increased fairly consistently in recent years; and those in manufacturing had tended to rise faster than wages in other sectors. He had taken note of the staff's comment that growth in manufacturing had been hampered, inter alia, by increased competition from neighboring countries. Presumably, cost competitiveness was one aspect of that increased competition.

Finally, on the matter of arrears, Mr. Fox said that he welcomed the authorities' intention henceforth to make explicit provision for repayment in the budget. He could also go along with the plan to increase domestic borrowing modestly in order to accelerate repayments, although, like the staff he would urge the authorities to be cautious in taking such action. The authorities should also take the opportunity of any improvement in economic conditions to accelerate the planned elimination of arrears.

The staff representative from the Western Hemisphere Department observed that while St. Lucia's arrears were certainly contractual, most of them were not arrears on debt per se; a substantial amount represented arrears on contributions to some of the regional institutions, including the University of the West Indies, and some arrears were on treasury obligations denominated in local currency. While most countries with an established capital market would be able to roll over some of those treasury obligations by issuing new obligations and refinancing, such flexibility was not possible in a country where no well-developed capital market existed. To the extent that treasury issues were purchased by a neighboring government, the authorities were required to honor the debt and did not have the flexibility to issue a new security to refinance it. Part of the arrears problem in St. Lucia was related to the effort to keep current with the treasury bills denominated in local currency. As noted by Mr. McCormack, however, the authorities were in the process of contacting some of their creditors with a view to reissuing new treasury bills and thus removing the arrears. They had also contacted the University of the West Indies and other institutions to which contributions had been late to see whether a new schedule of payment of those contributions could be worked out. In addition, the authorities had made a serious effort to make direct cash repayments to suppliers and other creditors.

On a related matter, the staff representative noted that, given the uncertainties in estimating consumption taxes when the staff report had been prepared, the projections tended to underestimate the contribution of those consumption taxes to the budget. Once those taxes were put into effect--and they had already been approved--they would no doubt make a more positive contribution in the budget than was indicated in the staff report and, to that extent, the authorities would be able to follow through on their intention to accelerate the repayment of arrears.

Remarking on the development program and the balance between tourism and manufacturing in that program, the staff representative observed that St. Lucia, like some of the smaller islands in the Caribbean, was looking toward the upper end of the market and focusing on projects that would cater to the wealthier tourist. Analysis had shown that the most expensive hotels were those most often filled and that, despite the obvious competition, the projects being undertaken in St. Lucia were sufficiently specialized that the economy was unlikely to suffer from increasing costs that might develop through higher wages. The situation with respect to manufacturing was not so simple. In manufacturing, St. Lucia was open to competition with other countries, and rising wages were no doubt an element in the competitiveness question, although factors like labor organization might be more important, since absolute wage levels remained fairly low in St. Lucia and in the region more generally.

Mr. McCormack thanked his colleagues for their constructive remarks, which he was certain would be given full consideration by his St. Lucian authorities.

The Acting Chairman made the following summing up:

> Directors expressed general agreement with the appraisal contained in the staff report for the 1986 Article IV consultation with St. Lucia. They noted that economic activity had continued to grow vigorously in the last two years, that unemployment had been reduced from a very high level, and that inflation remained low. The strong growth in banana exports and tourism had resulted in a marked strengthening in St. Lucia's overall balance of payments and in a substantial buildup in commercial banks' reserves.

Directors welcomed the significant improvement in the savings performance of the Central Government during FY 1986/87, which had enabled the Government to reduce the stock of overdue obligations for the first time since they began accumulating in 1981. To consolidate these improvements and also to permit an acceleration of the timetable for the settlement of remaining arrears, Directors cautioned against any relaxation of their fiscal stance. They also urged the authorities to implement promptly the upward revision in the consumption tax rates that had already been approved, to exercise the utmost restraint on the occasion of the forthcoming round of wage negotiations, to screen carefully capital projects financed with domestic resources, and to encourage foreign investment.

It was observed that, although some recourse to credit from the domestic commercial banks to reduce arrears could be justified, in view of the strong liquidity position of the banks, reliance on such credit for purposes other than reducing arrears should be avoided.

While observing that the index of the real effective exchange rate has declined substantially in the last two years and that the medium-term outlook of the balance of payments appears to be favorable, speakers encouraged the authorities to continue to monitor closely exchange rate and cost competitiveness of the economy within a regional context. Noting the authorities' commitment to the current exchange rate arrangements and the readiness of the authorities to accept the domestic policy constraints which that commitment entails, Directors reiterated the need for a prudent wage policy to help strengthen the public finances and to avoid an erosion in the external competitiveness of the economy.

It is recommended that the next Article IV consultation with St. Lucia continue to be held on an 18-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/41 (3/6/87) and EBM/87/42 (3/9/87).

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAP/87/44 (3/5/87) is approved.

6. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/87/45 (3/6/87) is approved.

APPROVED: October 7, 1987

LEO VAN HOUTVEN
Secretary