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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/123

10:00 a.m., August 26, 1987

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
Dai Q.	
	M. K. Bush
	M. Lundsager, Temporary
	J. Prader
	M. Hepp, Temporary
	M. B. Chatah, Temporary
	B. Goos
J. E. Ismael	
	J. Hospedales
T. P. Lankester	S. King, Temporary
	D. A. Woodward, Temporary
	D. McCormack
	G. D. Hodgson, Temporary
	C. V. Santos
	I. A. Al-Assaf
	V. J. Fernandez, Temporary
J. Ovi	J. Fogelholm
H. Ploix	S. de Forges
	G. P. J. Hogeweg
C. R. Rye	
G. Salehkhou	
	L. E. N. Fernando
K. Yamazaki	
	S. Rebecchini, Temporary

L. Van Houtven, Secretary and Counsellor
V. Wall, Assistant

Also Present

IBRD: R. W. Grawe, Africa Regional Office. African Department: A. D. Ouattara, Counsellor and Director; G. E. Gondwe, Deputy Director; J. Artus, T. R. Muzondo, E. M. Taha, R. C. Williams, P. M. Young. Asian Department: P. R. Narvekar, Director; U. Baumgartner, W. M. Tilakaratna. European Department: M. Russo, Director; M. Guitián, Deputy Director. Exchange and Trade Relations Department: S. M. Fries, H. B. Junz, S. Kanesa-Thasan. IMF Institute: S. Kufeni, Participant. Legal Department: F. P. Gianviti, Director; P. L. Francotte, J. M. Ogoola, J. K. Oh. Western Hemisphere Department: S. T. Beza, Director; M. Caiola, Deputy Director; J. Ferrán, Deputy Director; J.-P. Amselle, R. Pearson, S. J. Stephens, K. Thugge. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: L. P. Ebrill, G. Pineau, D. C. Templeman, A. Vasudevan, J. E. Zeas. Assistants to Executive Directors: A. R. Al-Abdullatif, F. E. R. Alfiler, O. S.-M. Bethel, H. S. Binay, E. C. Demaestri, F. Di Mauro, S. K. Fayyad, S. Guribye, K.-H. Kleine, K. Kpetigo, T. Morita, J. A. K. Munthali, L. M. Piantini, S. Rouai, V. Rousset, D. Saha, B. Tamami, H. van der Burg.

1. ZIMBABWE - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 consultation with Zimbabwe (SM/87/188, 7/31/87; and Sup. 1, 7/31/87). They also had before them a background paper on recent economic developments in Zimbabwe (SM/87/212, 8/14/87).

Mr. Abdallah made the following statement:

Following the strong recovery of 1985, some worrisome developents re-emerged in the Zimbabwean economy in 1986, which have either persisted or intensified in 1987. Another cycle of adverse weather conditions has seriously affected agricultural production with consequential implications on overall economic activity, given this sector's significant contribution to GDP. The situation is being aggravated by the deterioration in the terms of trade, shortages of imported raw materials and intermediate goods for the manufacturing sector as well as by the disruption of transport routes. In consequence, real GDP virtually stagnated in 1986 and is expected to decline by about 1.9 percent in 1987.

As a result, the economy started to experience internal and external imbalances in 1986. The rate of inflation accelerated and is expected to remain high in 1987, reflecting mainly supply constraints owing, in part, to continued import compression. At the same time, the fiscal deficit, though lower than the original budget estimate, widened in 1986/87 and is projected to be reduced slightly in 1987/88 in line with the objectives of bringing it to a sustainable level in the medium term. In the external sector, although the current account deficit of the balance of payments narrowed in 1986, the overall payments position worsened somewhat, mainly as a result of shortfalls in long-term capital inflows and an increase in debt service payments. Gross reserves fell to more than 11 weeks of import coverage from about 12.5 weeks in 1985. However, the outlook for 1987 indicates an intensification of payments pressures as a drawdown of reserves is expected to accelerate with debt service payments peaking at 40 percent of exports of goods and services.

It was against this background that the authorities announced on May 28, 1987 some corrective measures, which were reaffirmed in the budget statement on July 29. These constitute an interim package of policy measures whose principal objective is to stimulate investment and restore growth to its potential level while maintaining stable financial conditions in the medium term. It may be recalled that a growth target of 5 percent a year was incorporated in the Five-Year Development Plan (1986-90). In the light of current developments, modifications are expected to be initiated in the context of annual plans. In this connection, the authorities agree with the staff that growth prospects over the remainder of the planning period would crucially depend on the revival of investment in both the private and public sectors. They have also pointed out that the problem with domestic investment is not so much with the lack of investable funds. Rather, investment has been partly constrained by the lack of foreign exchange to secure imported raw materials and intermediate and capital goods.

As regards financial policies, the authorities are in agreement with the staff on the need to reduce the fiscal deficit. However, a deficit reduction of 9 percent of GDP projected by the staff over the medium term implies an annual deficit reduction of 2.25 percent which my authorities consider to be too ambitious in the context of Zimbabwe and in the light of the Government's socio-economic objectives. Instead, a deficit reduction at a rate of about 1 percent annually could be regarded as feasible. In drawing up the 1987/88 budget, the Government had to make adequate provision for drought relief and for the changing political situation in South Africa. The implied reduction of the deficit is nevertheless in line with the medium-term objective that seeks to rationalize overall government operations.

On the expenditure side, the wage bill is being increased by only 10 percent, which is lower than the projected rate of inflation and represents half the increase allowed in 1986/87. This also reflects a temporary wage freeze that was announced on May 28. In the area of public enterprises, the Government is currently studying the report of the Committee of Enquiry into Parastatals. It is intended to accelerate the implementation of the recommendations of this committee in order to promote efficiency and thereby reduce and, wherever possible, eliminate recourse to budgetary support.

On the revenue side, it should be pointed out that revenue remains a high proportion of GDP, indicating the high responsiveness of tax revenues. In the case of excise taxes, the Government is conscious of the fact that further emphasis in this area could result in diminishing returns and loss of revenue. This occurred in 1983, and it is feared that the phenomenon is once again emerging in 1987 in respect of clear beer, whose demand is currently shifting toward lower priced traditional beer. The same trend is being observed in respect of tobacco. In general, the authorities believe that emphasis on consumption taxes runs the risk of stifling consumer demand, thereby lowering the volume of sales resulting in lower revenues. The reduction in the customs surtax from 20 percent to 15 percent was expected to benefit investment by reducing the cost of raw materials and capital goods on which this tax is applicable.

While the authorities agree with the assertion that monetary policy has been somewhat accommodating, they would like to stress that this has not prejudiced the private sector as there is no evidence of crowding out. Meanwhile, money supply has grown on average at a rate lower than the rate of growth of nominal GDP. Thus far, financing of the budget has not been inflationary, because the Government has relied principally on nonbank sources.

As regards the level of interest rates, the authorities agree with the observation that deposit rates have become negative in real terms since the upsurge in the rate of inflation. They believe in the important role of positive interest rates in mobilizing domestic savings for investment. To this effect, they will continue their efforts to achieve positive real interest rates through a reduction of inflationary pressures. However, they note that despite the low interest rates, commercial banks continue to experience excess liquidity owing to depressed private sector demand for credit.

In the external sector, the authorities wish to emphasize that the country's balance of payments difficulties are rooted in the exogenously determined variations in the demand and supply of their key export commodities, which are mainly primary products with a low price elasticity. Furthermore, the weak export growth has been associated with the effects of drought and other structural problems. In these circumstances, the authorities believe that the role of the exchange rate, which has been managed flexibly since 1982, should not be exaggerated. They have indicated that they will continue to pursue a flexible policy but stress that the exchange rate should not be allowed to bear a disproportionate burden of adjustment. Meanwhile, steps are being taken to liberalize import control on a phased basis as the Government believes that this would benefit the export promotion program which is already under way with the support of the World Bank. A bridging loan amounting to £70 million has been secured for this purpose.

The measures announced on May 28, 1987 in respect of transfers of dividends and profits should not be taken as an intentional change in policy toward intensification of restrictions. As clearly outlined in the Minister's statement, the Government was reluctant to take these measures even on a temporary basis. However, they were considered necessary as a short-term device to reduce or even halt the continued bleeding away of the economy under the prevailing severe foreign exchange shortage which has crippled domestic investment and production. It may be recalled that following the imposition of similar restrictions in 1984, a partial liberalization was undertaken in early 1986 when the balance of payments showed some improvement. Thus, there is no doubt in the minds of the authorities that the current measures are temporary to be lifted as soon as the payments situation improves.

In conclusion, I should like to emphasize that my Zimbabwean authorities recognize and appreciate that liberalization of foreign trade and appropriate domestic price and investment policies could promote efficiency in the economy. They are also in agreement with some of the recommendations incorporated in the staff's appraisal, including the reduction of the budget deficit and improvements of operations of the parastatals. The main difference of approach is basically one of timing and the speed of adjustment in areas such as the budget and price and import liberalization. Furthermore, in analyzing developments in the economy, the authorities wish to emphasize that due regard should be paid to the particular situation prevailing in the country and its historical background. Thus, although the economy is well diversified, its capital is basically monopolistic and foreign owned. The Government has been making efforts to redress this situation while endeavoring to achieve a high level of economic development.

Mr. Hogeweg made the following statement:

Economic conditions in Zimbabwe have fluctuated in recent years. External factors, weather cycles, and domestic policies have contributed to this unstable pattern, and in 1987 the economy is clearly faced with the prospect of a decline. Zimbabwe evidently has been operating below its growth potential, a trend that is likely to continue if policies are not changed.

The staff report indicated that with a comprehensive policy effort Zimbabwe should be able to attain higher growth rates and standards of living in the medium term. I fully share this view. Although the staff report for the previous Article IV consultation with Zimbabwe essentially contained the same message, the authorities' response thus far has been disappointing. The outcome for government finances has been even worse than expected. The budget deficit is high and unsustainable. The envisaged improvement in the coming year rests to a large extent on temporary factors; moreover, the thrust of the new tax measures would seem to promote consumption while investment is what is needed.

Many measures to which the authorities have resorted are understandable. For instance, the pricing of food crops reflects the desire for income redistribution. However, market prices change more rapidly than administered prices, with the result in Zimbabwe that farmland is being inefficiently devoted to a variety of crops. As a consequence, the Grain Marketing Board has suffered mounting operating losses which, in turn, strain the budget and the balance of payments. Likewise, pricing policies and inefficiencies of the parastatal enterprises contribute to budget and balance of payments deterioration. When inflationary pressures are countered with price controls, short-term cosmetic gains in price performance carry the cost of suboptimal allocation of resources. In order to save on scarce foreign exchange, a system of licenses exists whereby investment projects have to be approved. The criteria used to judge the projects lead to protection of existing industries and still more inefficiencies. Because of the short-term balance of payments situation, profits are restricted in that they cannot be remitted abroad. However, that practice diminishes business confidence and discourages foreign capital inflows, which, in turn, aggravates the balance of payments problem. Thus, the economy becomes more rigid and less able to respond to world market developments.

In the medium-term scenario for growth, the staff details the appropriate macroeconomic and structural policies. However, rigidities and inefficiencies have been built up in the economy in response to social and political commitments and to adverse external developments; therefore, it is difficult to know where to start with policy reforms. Moreover, reforms may lead to even larger external deficits in the short term--a development more noticeable than their longer-term impact on growth. A strong reduction of the budget deficit is a prerequisite to make room for higher capital formation and growth, a reduction the staff clearly feels is feasible. In that connection, a better performance by parastatals--in improved pricing policies and cost reductions--is essential. The staff also rightly proposes strict limits on the expansion of the civil service. Furthermore, the operating losses of the marketing boards can be reduced significantly only by changing the structure of prices of agricultural products. Table 3 of the background paper shows the rigidity of these prices in recent years.

The staff assumes a liberalization of the system of foreign exchange allocation and the import regime, along with an active exchange rate policy in its growth scenario. Insofar as competitiveness is enhanced currently by artificial pricing measures, a real depreciation of the exchange rate is warranted, but the authorities are reluctant. As always, exchange rate changes should be accompanied by appropriate domestic measures, one of which is to liberalize the control of domestic prices and investments in order to promote competition for highly protected domestic industries. Monetary policy has a role to play in containing inflation and mobilizing domestic savings by allowing interest rates to reflect the true supply and demand conditions.

Without these measures the economy could continue to struggle along, but the high growth scenario, which is clearly superior, would necessitate additional balance of payments financing. However, if the policies outlined by the staff were adopted, the international financial community, including the Fund, would be ready to assist.

I support the proposed decision.

Mr. King said that Zimbabwe continued to have considerable economic potential. Its infrastructure was well developed; the productive base was strong; the external position remained manageable--all of which were important achievements. Nevertheless, recent developments had been disappointing in several respects. Growth had been only modest in the previous five years; inflationary pressures had continued and, in underlying terms, might even have become worse than a cursory glance at the statistics would indicate; and the external position remained under pressure partly as a result of a disappointing export performance.

At present, Zimbabwe stood at a crossroads, Mr. King continued. The confidence of the international financial community in the authorities' resolve appeared to be weakening. The medium-term economic scenarios developed by the staff indicated that present policies were unlikely to generate the needed growth. However, there was considerable agreement between the staff and the authorities on what needed to be done to improve the outlook. For example, strengthening the fiscal position was clearly essential. The deficit had remained at a high level in recent years while at the same time a change in the composition of public expenditures had produced strong growth in current expenditure and transfers to the parastatals. Meanwhile, capital expenditure had stagnated. The deficit had been financed in part by blocking the funds of nonresidents--a measure that was unlikely to promote direct investment, which had been negligible in recent years. Fiscal policy also had added to the strains on other areas of the economy and might have contributed to the authorities' recent decision to impose a temporary wage freeze. A significant reduction in the fiscal deficit would help to ease those pressures and create the background to achieve a more rapid growth rate by freeing resources for the private sector.

The recent budget was disappointing, Mr. King went on. Although the overall deficit was expected to fall and the composition of expenditure to improve, the deficit was still likely to remain at a high level. Furthermore, some of the improvement was the result of one-time factors such as gold sales. Thus, further measures to reduce the deficit were needed, and if they were to promote faster growth, they would also need to be supported by other measures, particularly on the structural front.

The current controls on wages, prices, and foreign exchange had led to distortions in the economy and dampened investment, Mr. King said. In addition, those controls might have encouraged an inward-looking structure of production, which would explain the relatively weak export performance, and might also be part of the reason why employment growth had been weaker than expected. Therefore, it was encouraging that the authorities intended to shift their industrial policy toward promoting exports while pursuing efficient import substitution.

While the external position had been manageable, the underlying situation was under considerable strain, Mr. King commented. The external debt burden had continued to rise, and imports had had to be severely compressed, which had resulted in adverse effects on domestic production. The Reserve Bank of Zimbabwe had been forced to continue selling external securities. The disappointing stagnation of exports was the principal reason why imports had been so compressed.

The authorities had allowed the real effective exchange rate to depreciate gradually during the first half of 1986, and although little further action had been taken during the second half of the year, some further depreciation had occurred early in 1987, Mr. King remarked. Nevertheless, sizable export subsidies continued to be necessary for some goods, which suggested that the exchange rate was still on the high side. Maintaining a flexible exchange rate policy would be important if the strains on the external position were to be accommodated and if the present complex system of foreign exchange allocation was to be streamlined and liberalized.

The authorities had taken out a bridging finance loan with some commercial banks earlier in 1987 in the expectation of repaying it once an export promotion loan had been agreed with the World Bank, Mr. King noted. It would be interesting to know, perhaps from the World Bank staff representative, the status of that loan at present.

Despite the efforts in recent years, much remained to be done if Zimbabwe's economy was to realize its full potential, Mr. King said in closing. A consistent package of measures was needed to allow a significant liberalization of the economy while at the same time easing the external constraints.

Mr. Chatah made the following statement:

> The economy of Zimbabwe, like many other sub-Saharan economies, is vulnerable to exogenous developments such as changes in the terms of trade, weather conditions, and the security situation in the southern African region to which the Zimbabwean economy is intimately tied. The uneven economic performance in recent years is, at least in part, a reflection of this vulnerability. However, Zimbabwe enjoys a number of advantages that should help the authorities improve the general economic performance and achieve the country's economic potential, among which is a fairly diversified economic base, a relatively developed institutional framework for economic management, a manageable external debt situation, and normal relations with external creditors. In these circumstances, it should be possible to move more decisively in adopting and implementing a medium-term, growth-oriented adjustment strategy that minimizes at the same time the social and political impact of abrupt economic changes to which the authorities understandably attach particular importance.
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> In order for growth and employment to improve in a sustained manner, it is essential that the rate of capital formation, which has been stagnant for some time, increase significantly. Therefore,

that the 1987/88 budget includes a shift from current to capital spending is welcome. However, to the extent that the increase in public sector investment is not accompanied by a significant reduction in the overall fiscal deficit, the authorities may be forced either to increase their borrowing significantly or to continue their policy of import compression, which has already had a negative impact on the availability of inputs and thus on capacity utilization and productivity of existing capital. In this connection, the small reduction in the deficit envisaged in the new budget is, at least in part, the result of a one-time increase in certain revenues that cannot be sustained. The underlying fiscal position suggests, therefore, that consideration be given to raising taxes on consumption, which will also move more of the country's resources to saving and investment. Also, for capital formation to be sustained over the medium and long term, the environment for private sector investment activity should be improved. While steps already taken in this area are welcome, it is clear that a more comprehensive approach to the existing structural impediments to private sector investment will be needed.

Another important medium-term objective is to increase employment opportunities, particularly in view of the growing labor force. While the authorities' efforts to achieve that objective by improving education and vocational training are helpful, it should also be recognized that the level of employment is influenced by demand factors as well. Thus, the prospects for meaningful employment are closely tied to the investment and growth outlook. While the rapid increase in public sector employment in recent years may have mitigated the impact on unemployment of slow economic growth, in the long run the reliance on public sector employment may itself lead to a drop in productive employment opportunities in the overall economy. Moreover, to contain the wage bill by compressing the wage structure of a growing civil service may also reduce the incentives for skilled manpower in the public sector and thus its effectiveness as well.

The alternative medium-term scenarios constructed by the staff were quite interesting. Obviously, the Zimbabwean economy is influenced by many exogenous variables, and one needs to approach any medium-term forecast with caution. Nevertheless, the conclusion drawn from these scenarios is that a steady improvement in the growth performance can be achieved while maintaining a manageable external position that necessitates the import restrictions which the authorities have had to rely on in the past.

In conclusion, we fully appreciate the difficult regional circumstances facing Zimbabwe and welcome the adjustment measures that have been taken already, as outlined in Mr. Abdallah's opening statement. However, a more comprehensive approach will be necessary if the economy is to realize its full potential.

Mr. Salehkhou made the following statement:

I agree in general with the thrust of the staff appraisal.

Since independence in 1980, Zimbabwe's economy--which has remained heavily vulnerable to exogenous factors, particularly weather and terms of trade--could be characterized by relatively sharp swings: in economic growth, in the rate of inflation, in the public deficit, and in gross domestic investment. Notwithstanding this unstable pattern, the authorities' achievements in addressing the country's socioeconomic conditions and in improving the distribution of income while maintaining the balance of payments position at a manageable level are commendable. However, these achievements were at the cost of a persistent decline in imports through intensified controls over foreign exchange and imports. These, in turn, were reflected in lower utilization of the existing capacity in industry and in continued stagnation in exports.

Despite corrective measures such as an increase in producer prices, growth prospects for 1987 are not promising. Agricultural products are estimated to decline, owing to drought; industrial output to be constrained by a shortage of foreign exchange; and production of minerals to remain stagnant, owing to continued sluggish world demand. While I agree with the staff comments that further supplementary measures--particularly larger adjustments in agricultural producer prices--would help contain the trading losses of the Grain Marketing Board and alleviate increasing pressures on the budget, I wonder to what extent these measures would increase output, given the dominant adverse effect of exogenous factors on the economy. In the light of the foreign exchange constraints, the authorities' determination to make the best use of available resources for export-oriented or import-substitution projects seems, under the circumstances, to justify the existing guidelines for investments and for monitoring the allocation of foreign exchange provided through surplus funds. It is encouraging to note Mr. Abdallah's indication that the authorities intend to remove these restrictions as soon as the balance of payments position is eased.

Public sector finances performance in 1986/87 remained an area of concern, as the deficit is estimated to rise further by 1 percentage point to 10 percent of GDP. The deficit, however, had little impact on inflation as it was financed mainly by nonbank domestic borrowing. Given the importance attached to education and health services, and the authorities' commendable commitment to timeliness in honoring the country's rising external debt, the scope for substantial reduction in current expenditures appears to be limited in the near future. Of particular importance in this regard is the increase in defense-related outlays necessitated by extremely hostile regional circumstances. Implementation of appropriate measures to increase revenues would eliminate the parastatals' dependence on budgetary support, reduce the budget deficit, and provide resources required for investment and growth.

Mr. Fernando made the following statement:

Mr. Abdallah succinctly noted the basic issue for the authorities when he said that the main difference of approach between the Zimbabwean authorities and the Fund staff was one of timing and the speed of adjustment in the key areas of the budget and price and import liberalization. Clearly, the authorities do not consider that the time is ripe for a major reorientation of the economy away from government intervention and toward market stimuli. The traumatic circumstances under which Zimbabwe achieved sovereignty has cast an enormous burden on the authorities--to repair and rehabilitate the economy while maintaining social and political stability through welfare schemes aimed at meeting basic needs. However, exogenous developments such as unfavorable terms of trade, a frequently adverse climate, and interruptions in transport service have rendered the authorities' tasks more complex and threatened to erode the social gains. The authorities are well aware of the vulnerability of the economic system to events beyond their control.

There are many reasons to be confident in the economy's capability of recovering. Potential for agriculture, livestock, and mining activity is rich. The production structure is diversified, as is the export base; the industrial base is developed, as is the financial system, by African standards. Good weather produces a strong agricultural supply response. In turn, this promotes strong personal savings.

Therefore, it comes as an unpleasant surprise to find capital formation and investment activity at levels too low to permit a reasonable growth rate. Though foreign exchange shortage is cited as an important reason, lack of skilled personnel and low capacity of project preparation and execution have impeded investment. As a result, donor support has become reluctant and there is a lack of demand for investable resources even when the system has been liquid. This would appear to be a priority area for attention if other growth promoting policies are to be adequately supported.

We agree with the thrust of the staff recommendation regarding the medium-term focus on output growth and internal balance. The authorities have clearly recognized the importance of price stimulus regarding agricultural products. This policy has made Zimbabwe self-sufficient in food staples, and export prospects appear good. The staff has recommended a reduction in real and nominal procurement prices to reduce the oversupply of some commodities as well as to improve the trading results of the procurement agencies. In this context, we wonder whether the price of maize, for example, would be out of line with world market prices if domestic prices were adjusted to reflect a realistic exchange rate. In any event, the authorities should exercise great caution before disturbing the price system for the basic food commodity, which is readily available and amply stocked in case of adverse weather.

We commend the steps taken by the authorities to reduce the burden of parastatals on the budget on the basis of a case-by-case review. An increased tempo of action in this regard will obviously accelerate the reduction of the public sector deficit, although sociopolitical imperatives limit the authorities.

Given that Zimbabwe has only a moderate deficit in its external accounts--admittedly achieved through import compression, and a respectable level of reserves--a strong policy package of reducing imbalances and promoting structural reform should provide firm prospects of sustained growth. Such policy would remove bottlenecks to investment and make the economy more resilient to variations in climate. Structural policies can perhaps be more thoroughly dealt with by the World Bank in a collaborative role in implementing the adjustment measures. Meanwhile, we can support the proposed decision.

Ms. Bush made the following statement:

The staff paper provides two dramatically different scenarios for the medium-term economic performance of Zimbabwe. By continuing current policies, Zimbabwe would seem on the one hand to be caught in a cycle of low growth and declining creditworthiness; on the other hand, with improved policies, Zimbabwe would move steadily forward on a path of strong growth with reduced balance of payments strains. If there is any bias in these scenarios, the first understates the risks and the second understates the advantages. I therefore encourage the authorities to adopt the policies necessary for the economy to break out of its cycle of low growth and declining creditworthiness.

The authorities should be particularly sensitive to the costs of delaying needed policy adjustments. On the basis of past performance, it would appear that the economy responds rapidly to changes in relative prices and other incentives, which would suggest that Zimbabwe's current problems have been brought on by macroeconomic policy weaknesses and that the costs of delay will be high.

The staff paper indicates the steps that need to be taken, the first of which is fiscal consolidation. We agree with the staff on the necessity and the feasibility of reducing the ratios of the overall deficit to GDP by about 9 percentage points over the medium term. In this connection, we were disappointed by the information in the supplement on the 1987/88 budget. While the emphasis on limiting current expenditures is welcome, the efforts reflected in this budget do not go far enough. In particular, it is critically important to reduce the burden on the budget of the parastatal sector. We welcome the work to date of the Commission on Parastatals and urge that its recommendations be implemented expeditiously. We also agree on the importance of containing the size of the civil service.

Stronger fiscal policy, however, will not have the desired effect without supporting actions in other policy areas--notably pricing, wages, exchange rates, trade, investment, and monetary policy. There is abundant evidence that Zimbabwe's system of administered prices is not conducive to growth; one might even say it is antigrowth. Corrective action in this area would be particularly beneficial, as stronger incentives for productive economic activity lead to increases in efficiency. We agree with the staff on the need for a more flexible mechanism for establishing wage rates in the private sector.

We recognize that there is not a lot of balance of payments pressure on the exchange rate, but we have the impression that the authorities are overlooking the possibility of using this policy instrument to break the current pattern of declining exports and imports. We are pleased that a working group will be set up to study changes in the import allocation system. The failure of this approach to rationing scarce foreign exchange resources is well documented, and we hope that the working group will recognize the link between import liberalization and growth.

Like the staff, we regret that the recent measures to liberalize the use of surplus funds for investment were linked to intensifying restrictions on the remittance of profits and dividends abroad. Again, relative to many of its neighbors, Zimbabwe is in a better position to reap the benefits of foreign investment. Thus, it is especially disappointing to find ongoing policies that discourage investment.

After the progress made between 1983 and 1985, it is unfortunate that the rate of inflation has returned to double digits. We believe that a less accommodative monetary policy--supported by other policy changes in the direction indicated above--will not be a constraint on economic growth. In this connection, we would like to echo the staff's view on the need for positive real interest rates.

In conclusion, since the Board's discussion of the previous Article IV consultation with Zimbabwe, prospects have worsened. Admittedly, exogeneous factors such as declining terms of trade

> have contributed. However, from a broad perspective, the disappointment we feel is derived from a sense that short-term considerations have produced a set of policies that are less growth oriented than the policies in place a year ago. We understand that there have been adverse factors beyond the control of the authorities. But, as brought out in the staff's two scenarios, a substantial change in policies will be necessary to restore a brighter outlook, sustained growth, and the external financing anticipated by the authorities.

Mr. Rye said that the staff report indicated that the policy stance of the authorities had changed very little since the 1986 Article IV consultation discussion in the Board. The points raised at that meeting--on fiscal policy, exchange rate policy, and wage/price ceilings--were precisely the concerns raised in the staff report for the 1987 Article IV consultation.

The authorities had maintained, even intensified, their controls over foreign exchange and imports in the face of weak export growth, rising debt payments, and falling official reserves, Mr. Rye continued. Although controls had enabled the authorities to avoid negative external positions and to keep debt payments current, they had also led to capacity underutilization, a sharp fall in investment, and had raised inflation and the level of unemployment. Those practices had clouded growth prospects.

Zimbabwe was endowed with a strong economic base and a well-maintained infrastructure, Mr. Rye went on. Therefore, notwithstanding the poor outlook for the immediate future and the difficult external environment, policy options were available to direct Zimbabwe to a sustainable medium-term growth path. Correction of imbalances in the public sector was critical, especially a more realistic public pricing policy and the containment of government wages through limitations on the number of civil servants. In general, policy needed to move from a control-oriented basis to one more consonant with the liberalization of market forces.

Mr. Santos made the following statement:

> The prospects for the immediate future in Zimbabwe are not bright. While we agree with the general thrust of the staff appraisal and endorse most of the policy recommendations that could lay the basis for Zimbabwe's economic recovery toward a sustainable medium-term growth path, we find it difficult to endorse some of the other policy options recommended by the staff, given their potential social and political impact and the weak external sector position. We have often stated that the staff should take into account the unique circumstances of countries in Africa when addressing their problems.
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> In the real sector, where production prospects are not encouraging because of the continued widespread contraction of agricultural output, especially maize, the staff believes that a reduction

in producer prices would encourage a speedy shift to other crops. In this regard, it must be recognized that during the past three crop years, the authorities have pursued a realistic and flexible producer pricing policy in order to improve producer incentives. Furthermore, the critical importance of maize in Zimbabwe--the recent drought made it necessary to import a substantial quantity of maize to meet domestic shortfalls--should be an important factor in determining whether to reduce the producer price of maize, given the existing foreign exchange constraint.

Wage and employment policies have aimed at reducing income differentials and raising the living standards of the lowest paid workers. The staff should not discourage the policy of giving smaller salary increases to higher-paid employees than to lower-paid ones.

As for external policies, the only way for the economy to get out of the so-called vicious circle of weak export and import growth was for the authorities to begin liberalizing the restrictive import system and for the market for Zimbabwean exports to expand significantly. An apppreciable improvement in regional security and transportation would also help. As soon as the pressures on the external payments position begin to ease, Zimbabwe will, as in the past, promptly remove the restrictions on current international payments and transfers that have been intensified recently. In any event, we would encourage the authorities to take the necessary steps to build and maintain investor confidence, bearing in mind that the pursuit of a flexible exchange rate policy should be adequately complemented by appropriate measures of financial restraint.

Mr. Goos said he was disappointed that the authorities had failed thus far to take any major initiative to tackle the pressing problems identified at the Board's discussion of the previous Article IV consultation with Zimbabwe. Thus, it was not surprising that Zimbabwe was faced with a deteriorating economy, reflected most notably in growing fiscal imbalances, accelerating inflation, poor investment and export performance, and increasing external pressures. Further delays in adjustment clearly threatened that the economy might fall into a vicious cycle of continued stagnation, or even decline, in exports, and increasing import and production constraints, which would feed back negatively onto investment activity, export performance, and growth. Therefore, it was worrisome that the authorities appeared to have resigned themselves to the circumstances. It would appear that the authorities perceived the existing problems as a necessary price to pay for maintaining their commendable record of prompt debt repayment. Of course, the authorities were aiming to reduce the existing imbalances, but the impression was that they were doing so at an unduly slow pace. However, there was little reason for pessimism, since the authorities had many promising policy options to choose from, as outlined by the staff in its medium-term scenario.

The staff representative from the African Department noted that the pricing policy of certain agricultural commodities, especially maize, had been questioned. The staff had recommended that the price of maize be maintained in nominal terms, which would allow a modest reduction in real prices. Currently, the price of maize in Zimbabwe was somewhat above the world market price.

In general, the wage policy in recent years had not improved the living standards of the lower-income workers, and the capability of the civil service had been diminished somewhat by the exodus of skilled workers and management personnel who had gone into the private sector, where wage policy was not as easily enforceable. While improving the welfare of the lower-paid worker was a desirable objective, ways should be found to accomplish it without squeezing the better trained and managerial level staff out of the civil service.

The staff representative from the World Bank remarked that in the coming weeks the World Bank staff would hold discussions with the authorities in Zimbabwe on the policies to address the external and internal imbalances that needed to be corrected before any progress could be made on the capital promotion project. An open dialogue existed between the World Bank staff and the authorities, but the succeeding steps depended upon the progress made in correcting the imbalances that had been identified in the Executive Board's discussion.

Mr. Abdallah commented that the concern of the authorities was deeper than some Directors appeared to believe. Within the next year significant changes would be made that had not even been mentioned in the Board that morning.

The Chairman then made the following summing up:

> Executive Directors agreed with the thrust of the appraisal in the staff report for the 1987 Article IV consultation with Zimbabwe. Zimbabwe is a diversified economy with strong growth potential and Directors observed with approval that the overall balance of payments and external debt position had remained manageable. However, they stressed that the uneven and generally deteriorating economic situation in recent years called for a more determined and comprehensive economic policy response to improve prospects for growth. Zimbabwe's growth performance has been on a declining trend reflecting export stagnation, import compression, and declining investment. Both exogenous factors, such as frequent droughts and depressed demand for mineral exports, as well as inadequate domestic economic policies have contributed to the weaker economic performance. The persistence of a large budgetary deficit remains a major source of imbalance, Directors observed. Rising debt service payments and declining foreign exchange earnings have recently led to intensification of controls over foreign exchange and imports, which have further reduced capacity utilization and undermined investment incentives.

Directors viewed the reduction in the budget deficit as the central issue in the development of a macroeconomic policy framework conducive to growth. While welcoming the deficit reduction target in the 1987/88 budget as a step in the right direction, they considered the deficit to be too high and unsustainable. Directors urged the authorities to strengthen the public finances on a lasting basis through further restraint on current expenditure, including in particular cuts in subsidies and civil service reforms. They also underscored the need for speedy implementation of new policy initiatives including price adjustments to eliminate the operating deficits of parastatals. Directors observed that fiscal restraint should be reinforced by an anti-inflationary credit policy without crowding out the private sector. A less accommodating monetary policy would be appropriate and interest rate policy should aim at encouraging mobilization of additional domestic savings.

Directors observed that the medium-term scenarios very clearly underscored the need for structural adjustment to lay a strong base for growth of output and employment. In this connection, Directors emphasized the need to stimulate investment through redistribution of resources to productive activities, both private and public. They pointed to the need for improving investment incentives and internal competition through more market-oriented pricing and for the phasing out of administrative controls in the goods and labor markets.

Directors commented that the substantial reduction in Zimbabwe's current account deficit in recent years had been achieved mainly through import compression through quantitative restrictions. They encouraged the authorities to stimulate exports through a combination of a more active exchange rate policy and structural policies to improve production incentives and to reform the highly restrictive import system. In this connection, Directors welcomed the recent renewed, albeit modest, depreciation of the Zimbabwe dollar in real effective terms and urged the authorities to maintain a flexible exchange rate policy so as to improve competitiveness more speedily in the future. Directors commended Zimbabwe on its prudent external debt management policy but cautioned against additional commercial borrowing, given the already high debt service burden. Directors were concerned about the recent intensification of restrictions on transfers of dividends and profits in particular in view of their likely adverse impact on the needed voluntary inflow of external resources, and they encouraged the authorities to reduce these restrictions as soon as possible.

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

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Zimbabwe's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1987 Article XIV consultation with Zimbabwe, in the light of the 1987 Article IV consultation with Zimbabwe conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in SM/87/212, Zimbabwe continues to maintain restrictions on payments and transfers for current international transactions in accordance with Article XIV, Section 2, except that the exchange restrictions arising from the limitations on remittances of profits and dividends are subject to approval under Article VIII, Section 2(a) and that the multiple currency practice arising out of the 20 percent fee on sales of foreign exchange for tourist travel and a 9 percent export subsidy are subject to approval under Article VIII, Section 3. The Fund encourages the authorities to take measures that will permit the elimination of these restrictions as soon as possible.

Decision No. 8682-(87/123), adopted
August 26, 1987

2. ST. KITTS AND NEVIS - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with St. Kitts and Nevis (SM/87/192, 8/5/87). They also had before them a background paper on recent economic developments in St. Kitts and Nevis (SM/87/200, 8/11/87).

Mr. Hodgson made the following statement:

Economic performance in St. Kitts and Nevis during the past three years in terms of output growth, inflation, and the overall balance of payments has generally been positive. That positive trend should continue in coming years. Financial policies strengthened during 1986 in support of sustained economic growth, and some important restructuring of the economic base has begun.

Sugar has long been a mainstay of the St. Kitts and Nevis economy, just as it has been a principal traditional source of economic activity for many other Caribbean countries. However, as elsewhere, the Government of St. Kitts and Nevis now faces the prospect of continuing weakness in the sugar industry, which will require not only a rationing of sugar production, but, more importantly, diversification of the economic base. The recently published National Development Plan for 1986-90 recognizes these needs, and calls on the private sector to play a pivotal role in encouraging other areas of economic activity, most notably export manufacturing and tourism. Tourism in particular is expected to experience rapid growth during the coming period. To support that effort, the public sector investment program is expected to accelerate sharply during 1987-89 in order to provide the required infrastructure. My authorities are mindful, however, of the absorptive capacity constraints and skilled labor shortages that may emerge, and it is their intention to monitor developments closely.

Efforts have already been made within the sugar industry to bring cane cutting and refining operations under one management. Furthermore, in early 1987, the Central Government assumed the industry's outstanding indebtedness to the National Bank, both to make the costs of sugar production more transparent and to improve the liquidity position of the National Bank. However, a 40 percent reduction in the U.S. sugar quota for St. Kitts and Nevis has forced a further re-evaluation of the viability of the industry. My authorities have already asked the World Bank for assistance in assessing the industry's prospects. In the meantime, sizable operating deficits will continue, and my aurhorities are carefully examining the staff's recommendation that government revenues should be increased by about 1.5 percent of GDP to cover the sugar industry's debt service costs.

My authorities agree with the staff that faster economic growth can best occur in an environment of strong and stable financial policies.

After strengthening during 1986, net public sector savings are expected to decline temporarily to about 3.5 percent of GDP in 1987, and the overall deficit is expected to rise to about 3 percent of GDP, in part owing to the sugar industry debt discussed above. Concessional external resources have already been identified to finance the entire overall deficit. The staff projects a recovery in the public sector current balance in 1988 to about 6 percent of GDP. Concessional external resources again should exceed the overall public sector deficit in 1988, permitting further reductions in public sector indebtedness to the local banking system.

The financial position of commercial banks has also strengthened during 1986/87, and commercial banks were able to reduce their prime lending rate by 1/2 percentage point in June 1987. Discussions are now under way between the Government and commercial banks on how more loans might be made available to low- and middle income borrowers, principally for residential mortgages.

The staff's medium-term balance of payments projections show some weakening in the external accounts for 1987/88, owing largely to increased imports related to public and private investment. However, as the number of hotel rooms and tourist arrivals increase strongly toward the end of the decade, along with other export receipts, the current account is expected to improve dramatically.

Concessional official resources and private investment are projected to cover fully the temporary widening of the current account deficit, and an overall external surplus averaging 1 percent of GDP is projected for the period to 1991. Consequently, St. Kitts and Nevis is not expected to require commercial borrowing, and debt servicing should be smooth. Further, the recent trend of the real effective exchange rate has helped to improve competitiveness for St. Kitts and Nevis, and the authorities see the exchange rate as appropriate.

Finally, my authorities in St. Kitts and Nevis agree to move to a 24-month consultation cycle, with an interim staff visit about the time of the Government's annual budget cycle.

Mr. Hospedales made the following statement:

Recent economic performance in St. Kitts and Nevis has been very satisfactory. St. Kitts and Nevis is clearly laying the foundations for a systematic and well-defined growth and development, through the implementation of a five-year development plan focusing on export-oriented industry and the expansion of tourism and nontraditional agriculture. The authorities expect to make deep inroads in reducing unemployment, which is now estimated at approximately 20-25 percent. What is even more disquieting, however, is that the bulk of the unemployed are highly untrained. Nevertheless, diversification will reduce the economy's vulnerability to external shocks; indeed its main export commodity--sugar--has been subject not only to volatile prices but also to insecure markets, its quota to the United States having been cut just recently by 40 percent.

The authorities are correctly emphasizing the promotion of national savings to finance higher private investment levels consistent with the objective of exploiting fully the economic potential of the country. Substantial progress has been made so far; public sector savings will average just under 5 percent of GDP over the two-year period 1987-88; to this end, revenue collection efforts are being enhanced and strict expenditure controls are in place. Additionally, emphasis on improving efficiency in the public enterprise sector is well placed. Nevertheless, to avoid slippages, strong action will be needed to bring about the required improvements in the sugar sector, given its recent vicissitudes. World Bank technical assistance is appropriate in this respect. In the interim, the authorities will be well advised to consider carefully the staff's recommendation to raise additional revenue to finance annual debt service payments on the sugar debt assumed by the Government; also, in the light of the small size of the private sector in St. Kitts and Nevis, the Government must be prepared to take appropriate action if the private sector is unable to provide a leadership role in this new thrust. Present discussions with the commercial banks are steps in the right direction.

The generation of appropriate public sector savings is facilitating in an important way the implementation of a public sector investment program endorsed by the World Bank, which will comprise about 17.5 percent of GDP in the period 1987-89. But significantly, 80 percent of the program is being financed externally on concessional terms. The importance of this infrastructure investment for tourism and nontraditional agricultural sectors cannot be overemphasized and should not overstrain the economy in the light of the large amount of idle and available resources. We would appreciate some comment from the staff on initiatives for improving the quality of the labor force.

The particular financing arrangements being pursued by the authorities--including the nondebt-creating flows, which should follow the infrastructure investments--will ensure that the debt-servicing capacity of St. Kitts and Nevis remains within manageable limits and the balance of payments sustainable over the medium term. The narrow export base is being expanded, but its further diversification will be facilitated by appropriate action to ensure that the present competitiveness of the exchange rate is not eroded. The competitiveness of the present fixed exchange rate policy of the authorities can be preserved only through appropriate restraints on wage costs, an area of potential instability given the stepped-up capital expenditure that has taken place.

Mr. Woodward made the following statement:

I agree with the staff appraisal. St. Kitts and Nevis's recent economic performance has been broadly satisfactory. Growth has continued at a reasonably high level, the rate of inflation has been reduced to zero, and the fiscal deficit has been reduced substantially. While the current account deficit remains fairly high, it is more than covered by concessional loans and foreign direct investment.

There are, however, one or two less positive features which merit attention. The staff report notes a significant deterioration in the fiscal position in 1987, with public sector savings falling by about half and the overall fiscal deficit increasing substantially. It will be important to ensure that the projected recovery of public savings in 1988 materializes, and this will mean both increasing revenues and restraining expenditure. I would also endorse the staff's advice that additional revenues of about 1.5 percent of GDP be raised to offset the cost of servicing the debts taken over from the sugar sector, and I welcome Mr. Hodgson's assurance that this option is receiving careful attention.

Real wages have risen rapidly in recent years, particularly in the hotel and garments sectors. I would welcome the staff's view as to whether this might be an impediment to the development of these sectors and whether real wage levels generally are a significant factor in the current high level of unemployment. Despite the unemployment problem, there remains a significant shortage of skilled labor. In view of this shortage and the potential constraints it implies for sustainable growth, I was surprised that there was not greater emphasis on training in the section of the paper on development issues.

Turning to the projections, I would like to emphasize the risk noted by the staff that the increase in construction activity expected in 1988-89 might give rise to some economic strain. Again, the shortage of skilled labor would seem to be a significant factor. The sustained increases in the fiscal and current account balance of payments deficits could also give rise to problems, although I note that they are more than covered by concessional loans and, in the latter case, foreign direct investment. In view of these factors, I would join the staff in urging the authorities to keep a close watch on the pace at which they implement their investment program. I would also urge further measures to rationalize the operations of the sugar sector.

For the longer term, I wholeheartedly endorse the authorities' intention of diversifying the economy away from sugar. However, I would urge some caution with regard to tourism. A substantial number of countries in and around the Caribbean are currently seeking to promote their foreign tourism sectors as the main source of economic growth in the medium term, and it is unclear whether the aggregate number of visitors to the region will grow sufficiently to make all their aspirations consistent. Their expectations may have been raised unrealistically by the temporary diversion of North American tourists from Europe and the Mediterranean to the Western Hemisphere in 1986. This would seem to be a further argument for a cautious approach to infrastructure development specifically geared to the tourist sector.

I can support the proposed change to a 24-month consultation cycle.

Ms. Lundsager made the following statement:

Economic expansion in St. Kitts and Nevis has continued at a satisfactory pace, while inflation is remaining quite low. In addition, the overall balance of payments has remained in surplus owing to sustained, high private direct investment inflows. As a result, the debt service ratio is still minimal. Furthermore, in 1986, the authorities achieved a substantial reduction in their fiscal deficit. The authorities are taking a welcome approach to economic development, concentrating on creating an environment conducive to private sector development of competitive sectors such as tourism.

I would just raise one note of caution regarding the ambitious development goals of the authorities, relating to the future fiscal impact of current investment. The various infrastructural projects now being initiated will require operating and maintenance expenditures in the medium term, and careful cost accounting of all these items should be considered in the authorities' decision-making process.

The fiscal situation appears generally under control, with concessional financing providing funding for some of the infrastructure investment. A cautious approach to fiscal management is needed given the convergence of difficulties in the sugar sector with expansion of the capital budget. Mr. Hogdson noted that his authorities are examining the staff recommendation that they consider an increase in government revenues to cover the sugar industry's debt service costs. I would be interested in hearing if the authorities might also be considering additional expenditure constraint measures, since current expenditures are in the range of 30 percent of GDP. I realize that government wages were increased last year after several years of no adjustments, and would be interested in staff or Mr. Hodgson's views on possibilities for alternative expenditure measures.

This leads me to a final point regarding wages more generally. With the planned rapid expansion in investment, the staff noted that wage pressures could develop, which could be detrimental in the long run to maintaining the competitiveness of St. Kitts and Nevis, given the constraint of the fixed exchange rate of the Eastern Caribbean dollar. I would be interested in comparisons of wage rates in with those in other Caribbean islands. The authorities would be well advised to sustain cautious financial policies in order to contain domestic inflationary pressures that could emerge as the expansion of the tourism sector fuels domestic demand and that could adversely affect the nascent tourism and manufacturing industries later on. In that regard, exchange rate policies in the monetary union should be kept under constant review.

Excess liquidity in the banking sector could be a matter of concern, if demand for credit were to increase substantially. The authorities might reflect that as investment projects are initiated, related economic growth could bring about a higher demand for credit, and they should be prepared to exercise restraint if needed.

The staff representative from the Western Hemisphere Department said that it was difficult to make comparisons with the level of wages in other islands because the tax structures were different. In St. Kitts and Nevis, for example, there was no income tax; therefore, a direct comparison could be misleading.

Up until the present time, the authorities had been able to accommodate the demands of business for skilled labor through a training program that complemented in-house training in the business sector, the staff representative continued. However, recently there had been a stronger demand for skilled labor. The electronics industry in particular had had to train people abroad. In the fastest growing sectors, the industries had undertaken training programs themselves. The issue was a matter of concern for the authorities. The Government was hoping that a number of Kittitians who were currently working in neighboring islands of the U.S. Virgin Islands would return to St. Kitts and Nevis. In addition, the authorities had shifted their promotional emphasis from labor-intensive to capitalintensive industries. In that connection, the level of real wages had not so far been a problem because the tremendous productivity gains in private industry had been able to accommodate the increase in real wages.

The Government was committed to controlling expenditures, the staff representative noted. However, there was little additional scope to reduce expenditures. In a tourist oriented-economy, the Government's reduction in spending on repairs and maintenance on roads had an adverse impact because it was part of the tourist product.

Interest payments had been rising, the staff representative went on, which was part of the reason for the fall in public sector savings in 1987, and, hopefully, the Government would not borrow commercially any longer. Of course, the most important element was the trend in increase in real wages.

Efforts were being made to promote regional tourism, the staff representative from the Western Hemisphere Department remarked. St. Kitts and Nevis was starting from a very low base; consequently, there was a good opportunity to capture even a small part of the growth of world tourism and particularly Caribbean regional tourism. At present, the authorities were emphasizing a two-island stop so that the regional effort would indeed benefit the islands as a whole and especially any two islands linked together.

Mr. Hodgson noted that when the first Article IV consultation with St. Kitts and Nevis had taken place two years previously, the Board had expressed concern that the Government would draw upon domestic banking to finance a large fiscal deficit. Basically that problem had been dealt with. At present, the authorities were concentrating on economic development issues and concerns about capacity restraints and absorptive capacity, which was a healthy sign. The authorities had clear visions of where they were going. They understood the constraints they were facing and were beginning to deal with them.

The Chairman then made the following summing up:

Executive Directors were in general agreement with the thrust of the appraisal contained in the staff report for the 1987 Article IV consultation with St. Kitts and Nevis.

Directors noted that economic activity had been satisfactory in the last few years, inflation had become virtually nil in 1986, and the overall balance of payments had strengthened. While noting the substantial improvement in the public finances in 1986, Directors observed that because of certain special factors, a temporary weakening in the public finances was projected for this year. They made reference to the large operating deficits the sugar industry was likely to incur in 1987 and in the next few years, and advised the authorities to raise additional revenue in order to ensure a strong public sector savings position, thereby facilitating implementation of the planned public sector investment program.

Directors supported the Government's development strategy which stresses the role of the private sector in the expansion of exportoriented manufacturing, tourism, and nontraditional agriculture. In their view, such a strategy should contribute to the achievement of sustained economic growth and a viable balance of payments in the medium term. Directors noted that the rapid rise in construction associated with the public sector investment program and hotel expansion could create economic strains and said that the authorities should be prepared to take appropriate action to ease pressure on domestic resources.

Directors cautioned that an appropriate cost-price relationship was essential for the development of private investment and efficient resource use and they noted the shortage of skilled labor. They therefore stressed that the authorities should monitor closely the behavior of wages in both the public and private sectors to avoid slippages in the country's international competitiveness.

It is recommended that the next Article IV consultation with St. Kitts and Nevis be conducted on a 24-month cycle.

3. SOLOMON ISLANDS - 1987 ARTICLE IV CONSULTATION

Executive Directors considered the staff report for the 1987 Article IV consultation with Solomon Islands (SM/87/193, 8/5/87). They also had before them a background paper on recent economic developments in Solomon Islands (SM/87/201, 8/10/87).

Mr. Rye made the following statement:

My authorities are in broad agreement with the staff's analysis and with the agenda for policy action outlined in the staff appraisal. With the benefit of continuity of mission leadership, the staff has been able to develop a fuller understanding of Solomon Islands' economic and financial situation.

My authorities do, however, have reservations about several points in the report where the need to use numbers for presentational purposes suggests a precision that could be misleading. In several key areas--particularly the national accounts and balance of payments projections--the numbers are derived from weak data series or--as noted in Annex V of the staff report--include substantial interpolations. The authorities have measures in hand to improve the statistical base of the economy, but it will take time.

My authorities expect the 1987 current account deficit to be considerably smaller than indicated in the staff report. Net export earnings are likely to be 10-15 percent higher than earlier estimates while imports, reflecting signs of demand restraint, may be 10-15 percent lower. With the expected receipts of STABEX transfers, this will produce a balance of payments surplus, enabling the authorities to repay the US$5 million outstanding on the Eurocurrency facility while maintaining end-year reserves equivalent to three months' imports of goods and services. My authorities believe that the very open structure of the economy and the substantial swings experienced in export returns in recent years underscore the need to treat any medium- and longer-term balance of payments projections with great caution.

The acceleration of money supply growth is a cause of concern. The evidence points to this being driven by the budget deficit. This problem can only be addressed by fiscal policy measures. Although the banking system is highly liquid, banks show little inclination to run down liquidity other than in consultation with the Central Bank, which retains considerable influence over the direction and volume of lending and, to a lesser extent, deposits accumulated during the rapid expansion of money supply. The desire of the authorities to wind back interest rates by a few percentage points from their present high level is aimed at eliminating unnecessary cost inflation from the interest rate structure; the authorities recognize the need for real interest rates to remain positive.

In 1987 budget revenue and expenditure will turn out substantially--US$5-10 million--higher than estimated, and the net deficit will be rather lower than estimated at the time of the staff mission.

For 1988, the Ministry of Finance expects to propose substantially lower overall and domestically financed budget deficits than the actual 1986 or forecast 1987 outturns, and with a higher level of confidence in achieving budgeted results. Meanwhile, the Government has adopted as a key plank of the 1988 budget a guideline under which net new domestic borrowing would be rolled back to US$10 million, or about 5 percent of money GDP--compared with

US$20 million or 12 percent in 1987. Legislation will be introduced embodying the first moves toward tax reform recommended by the recent Fund mission. A review of the role and costs of the public sector is under way and there is a growing sense in the community of the need to reverse the trend to "big government." In this context, the authorities have put in place a system of recording and accounting for STABEX funds, including their use in long-term public sector investments. Unspent STABEX balances are kept out of the domestic money supply.

Looking ahead, the goal of the authorities is to achieve sustained real growth of GDP in excess of the 3.5 percent population growth rate, to provide scope for a progressive increase in, and redistribution of, economic welfare consistent with the social and political framework of the country. To this end, the authorities' main economic objectives are to halt the expansion of the Government's domestically financed deficit and reduce its absorption of domestic savings; increase the role of the private sector; improve the efficiency of the tax system, and sharpen fiscal management, particularly in relation to public investment, the use of foreign aid and the ongoing current costs of capital investment; and to maintain competitiveness of the tradable goods sector, avoid unsustainable levels of debt service and broaden the export base of the economy.

Finally, my authorities are grateful for the help of the recent mission in connection with a possible structural adjustment facility loan in 1988. This seems to be the form of Fund assistance most likely to be appropriate to the circumstances of Solomon Islands and the authorities intend to consider this option after the 1988 budget is in place and economic prospects are a little clearer.

Mr. King made the following statement:

The staff report makes clear the difficult environment the authorities in Solomon Islands have faced in recent years. The fall in the terms of trade in 1985 and 1986 was compounded by adverse effects of the cyclone of May 1986. These developments help to explain the sharp rises in the current account and budget deficits in recent years to extremely high levels. As Mr. Rye notes, these sharp fluctuations also underscore the need to treat medium-term projections with some caution. One might also argue that they imply that the authorities should use any available opportunities to build up their resources from their currently relatively low levels.

In coping with the recent shocks, the authorities have benefited from significant flows of STABEX grants which have helped to ease the adjustment process. Nonetheless, as the staff report makes clear, these flows may well decline in future years, emphasizing the need for the authorities to put the appropriate policies in place, if an excessive debt accumulation is to be avoided.

The authorities seem to be well aware of the need to strengthen the external position, as reflected in the maintenance of a flexible exchange rate policy that has helped to preserve the profitability of the export sector. Despite the fall in the real exchange rate, however, profitability remains under pressure in some key areas--notably the fishing sector. It is obviously important that the sizable investments in fishing equipment that are currently being put in place are self-financing and do not require budgetary support. This implies that the authorities will need to continue to carefully monitor trends in the key export sectors when setting exchange rate policy.

The authorities also recognize that fiscal policy will need to be tightened if the pressures on monetary policy and the external position are to be eased. This is particularly important as relatively little progress has been made on the fiscal front in the past year despite the various policy changes that were reported to be under examination at the time of the 1986 Article IV discussion. There also seem to have been slippages in some areas during 1987, including civil service pay. It is therefore encouraging to see that the authorities have begun to implement the first stages of tax reform following the recent technical assistance mission. Further measures will obviously be required in due course, however, and it was interesting to see that a consensus is developing against "big government." As the staff suggests, it would have been difficult to restore fiscal balance by revenue increases alone, and a more fundamental review of expenditure priorities would seem to be required.

In addition to prudent demand-management policies, additional structural reform measures will also be required if the economy is to achieve the rapid growth rate required to increase living standards against the background of the rapid rate of population growth. The steps being considered to create a more positive climate for direct investment will be helpful in this connection. The authorities are also tackling the land tenure problem. Although this is a difficult issue, it is also an important one. Uncertainties concerning land ownership have depressed investment in the forestry sector.

In conclusion, the authorities have faced a very difficult economic background in recent years. These problems have been eased to some extent by the receipts from STABEX. These flows are likely to decline over the medium run, however, and, as the authorities recognize, the need is clearly for measures to tackle the internal and external imbalances. In this light, I hope that the authorities will be able to formulate a policy package in the near future which could be supported under the structural adjustment facility.

Ms. Lundsager made the following statement:

The aftermath of the cyclone still poses difficulties for Solomon Islands, as indicated by the continuing costs of the reconstruction effort and slow recovery in volume of some traditional exports. The authorities appear determined to restore the productive capacity of their economy, while promoting growth and furthering economic development. The stated goals of the authorities are welcome, with the emphasis on generating appropriate pricing signals in the economy while encouraging private sector activity. We can fully endorse these goals, although we have some reservations that some of the policy approaches being taken by the authorities may not be fully conducive to attaining those goals.

Clearly, a stronger fiscal effort will be required, if sustained domestic growth and development in the medium term are to materialize. Mr. Rye mentioned that the fiscal deficit this year will be less than expected at the time of the preparation of the staff report, and we wonder if any estimates are available. Since taxes already consume a large proportion of GDP, we would hope that the tax reform effort could focus on the incentive effects of taxation, as opposed to revenue-generating measures. The authorities, as Mr. Rye reported, "sense a need to reverse the trend toward big government," and we too would agree that the emphasis on fiscal control could more usefully fall on expenditure constraint. In that context, we recognize that external grants and concessional loans are helping to finance the capital budget, but we believe that caution should be exercised in formulating that investment plan, given the absorptive capacity of Solomon Islands and the recurrent costs that will arise from such investment. Can the staff visualize any particular expenditure categories that could generate savings?

Fiscal constraint could support a more restrained monetary policy, while simultaneously providing a more appropriate distribution of credit in the economy. The central bank appears to direct banks' lending policies, and perhaps a more liberalized approach to the allocation of credit could support a broader diversification of the economy. We would also add that at the present time, with the strong need for domestic resource mobilization, monetary policy should aim to attain positive real interest rates.

Turning briefly to the external accounts, Mr. Rye has noted that a much lower current account deficit is expected this year, which will permit some reduction in foreign credits, while increasing reserves back to the equivalent of three months of imports--a welcome development. We would be interested in any further thought that the authorities might have on exchange rate policies, since it appeared from the staff report that the authorities were leaning toward slowing the rate of depreciation. While we can understand the reasons for this, we would strongly urge the authorities to keep external policies under constant review, so as to maintain external competitiveness, which is critically important for a country whose exports account for about 70 percent of GDP. As Mr. King noted, direct investment could play an important role in improving the balance of payments. Supportive restrained domestic financial policies, which could help contain domestic cost pressures from wage increases, are also critically important, particularly when viewed from a medium-term perspective, when difficulties could emerge if domestic demand grows more rapidly than can be accommodated by domestic resource mobilization and concessional assistance.

In sum, Solomon Islands remains vulnerable to weather conditions and to changes in world market prices. More cautionary economic policies appear appropriate, in order to avoid any buildup of nonconcessional debt. In that light, an arrangement under the structural adjustment facility could be a most useful method of fostering this process, with the help of the Fund and the World Bank.

Mr. Hodgson made the following statement:

This chair understands very well the circumstance of a small tropical island economy such as that of Solomon Islands. The recent steep decline in the terms of trade alone would have tested economic management. Adding to the authorities' difficulties was the severe cyclone in May 1986, which resulted in loss of life and damage equivalent to as much as 10 percent of GDP. Events such as these show just how fragile the economies of small island nations are and why international organizations need to be sensitive to their special concerns.

It is fortunate that sizable donor resources, particularly through STABEX, are available to Solomon Islands. As the staff rightly points out, the inflow of large foreign grants does provide some time for taking the necessary adjustment measures to adapt to these difficult external circumstances. However, these grants must be used effectively.

In the present circumstances, macroeconomic policy in Solomon Islands needs to be a source of stability, in view of the wide fluctuations in economic activity and foreign exchange earnings. Strong efforts will be needed over the medium term to reduce the fiscal deficit to more manageable proportions. This will entail tough decisions with respect to expenditure, and efforts will be needed to broaden the tax base and increase the efficiency of the tax system. I would further agree with the staff's comments with respect to absorptive capacity and the development budget and the need to ensure that investment resources are used efficiently, with full accounting for recurring development expenditures.

The present high level of fiscal deficits results in crowding out of available credit to the private sector, a situation which cannot continue if private investment is to rebound. At the same time, existing inflationary pressures call for a cautious monetary policy. Both these factors point to the need for timely fiscal action in support of monetary policy.

Regarding external policies, there seems to be considerable scope for expanding output in the fishing industry as one means of broadening the economic base. It will be important to maintain adequate profitability in export industries such as fishing, and a flexible exchange rate policy is one way of ensuring that profitability is adequate.

Lastly, the staff paper briefly touches upon a number of structural issues that the authorities will have to address if the stop-go pattern of economic activity is to be replaced by a more sustainable growth path. We would expect that future staff reports on Solomon Islands will provide greater detail on these structural concerns and hope that negotiations on use of resources under the structural adjustment facility can be completed soon.

Mr. Yamazaki made the following statement:

Already suffering from the unfavorable economic environment and the damage by Cyclone Namu, the Solomon Islands economy has deteriorated further. Real GDP, adjusted for the terms of trade in 1986, has been negative for two consecutive years. Fiscal and external imbalances have widened significantly. These imbalances have been masked by exceptionally large inflows of foreign aid, but the medium-term prospect also seems much less promising. A large financing gap is expected to emerge as foreign aid, especially STABEX grants, recedes. In this context, the policies in the medium-term framework should be geared toward avoiding large foreign commercial borrowings without hampering the growth momentum.

To achieve this purpose, fiscal policy has the most important role to play. In addition to the stringent cut in current expenditures and the comprehensive tax reform, the authorities should address capital expenditure also. I have some sympathy for the authorities in the sense that to realize the growth potential of the economy, a certain level of effective investments, especially in the transportation system or other infrastructure sectors, will be justified. At the same time, from the viewpoint of the serious need for containing the budget deficit, capital expenditure should also be closely monitored. I urge the authorities to conduct a comprehensive review of the investment program, in order to give priority to implementation. In particular, those investments with a long gestation period or a large recurrent expenditure should be carefully considered. Reform of the foreign investment act may foster investments without putting unwarranted pressure on the budget balance.

In the face of the large public borrowing requirement and inflationary pressure, which has already placed an adverse influence on wage development, there is no alternative but to keep the stance of monetary policy restrictive. Interest rates should not be lowered until warranted.

The flexible exchange rate policy should continue to be vigorously pursued. In a small island economy like Solomon Islands, the profitability of industry heavily depends upon world commodity price and exchange rate developments.

Much remains to be done on the structural side. In particular, the land tenure system and the weakness in investment planning and implementation are sources of concern and have to be addressed in the forthcoming structural adjustment facility program. Before concluding, I would like to emphasize the importance of the quick adoption of adjustment measures. The seriousness of the distortions in the economy call for front-loading measures. From that point of view, I am a little disappointed to know that concrete measures have yet to be formulated on the fiscal side and will not be taken until late this year when the 1988 budget is submitted to Parliament. I am looking forward to the early formulation of these concrete measures with their specific timetables.

The staff representative from the Asian Department said that unfortunately there were no updated fiscal estimates at present. However, there were several areas in which the fiscal issue needed to be addressed. Public expenditure, especially administrative overhead cost, was foremost among those. The devolution of political power to the provinces had been going on for a number of years and had engendered a rather large administrative cost. The authorities were aware that large savings could be made in this area, but it was a political question and not easily solved.

Another way to save in the fiscal area would be to privatize some of the maritime transport activity where subsidies were quite large, the staff representative from the Asian Department remarked. Indeed, the authorities had plans to privatize some of the activities being carried out by the public sector at large budgetary cost. The whole investment program could also be tailored better to the absorptive capacity of the country, an efficiency that would result in some savings.

Mr. Rye agreed that fiscal consolidation was an essential element of macroeconomic policy in Solomon Islands in the future. As for the 1987 budget, it appeared that the outcome would be closer to the original estimate than the higher figure that the staff had contemplated at the time of its mission to Solomon Islands. Also, a significant amount of structural change was desirable, and, of course, policies to that end would be pursued in the framework of a program of reform, to be supported by a structural adjustment arrangement.

The Chairman then made the following summing up:

Executive Directors were in agreement with the thrust of the staff appraisal. They noted that the steep decline in export prices and the damage caused by cyclone Namu had severely affected the economy. Balance of payments pressures had intensified and the external outlook had worsened, but owing to an unexpectedly large inflow of foreign grants, the balance of payments outcome in 1986 was substantially better than projected earlier. However, as the amount of exceptional external financing was likely to decline in the next few years, strong adjustment efforts were needed now to correct the underlying imbalances.

In that context Directors emphasized the need for a substantial reduction of the budget deficit. They welcomed the authorities' intention to reform the tax system and stressed that tax reform should aim at both widening the tax base and increasing the efficiency of the tax system. However, speakers stressed that it was also necessary to curb the rapid growth of expenditure and review the present administrative system and the cost it engenders. While Directors saw the need for large development expenditure to realize the considerable growth potential of the economy and to meet the demands of the rapidly growing population, they also stated that the development budget had to be streamlined and tailored to the country's absorptive capacity and that foreign direct investment could make a valuable contribution to the development effort. Moreover, monetary restraint should not be eased for reasons of both internal and external balance.

Directors commended the authorities for the flexible exchange rate policy pursued since 1985, which had limited the erosion of export profitability and helped contain the growth of imports. They urged the authorities to maintain the flexible management of the exchange rate to ensure competitiveness, including that of the large investments planned in the fishing sector. Directors also expressed concern about rising wage demands and the adverse implications for employment and adjustment of real wage rigidity.

Directors urged the authorities to adopt a comprehensive economic program that would address both the structural weaknesses as well as the financial imbalances and that could be supported by the use of Fund resources under the structural adjustment facility.

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

4. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. de Forges at the conclusion of his service as Alternate Executive Director.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/122 (8/24/87) and EBM/87/123 (8/26/87).

5. EXECUTIVE BOARD - REPRESENTATION EXPENSES

The Executive Board approves the recommendation of the Committee on Executive Board Administrative Matters concerning the representation expenses of Executive Directors incurred outside Washington as set forth in EBAP/87/180 (8/17/87).

Adopted August 24, 1987

6. 1987 ANNUAL MEETING - EXECUTIVE BOARD - REPRESENTATION EXPENSES

The Executive Board approves the recommendation of the Committee on Executive Board Administrative Matters concerning representation expenses at the time of the 1987 Annual Meeting as set forth in EBAP/87/181 (8/17/87).

Adopted August 24, 1987

7. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/87/186 (8/24/87) is approved.

APPROVED: March 18, 1988

LEO VAN HOUTVEN
Secretary