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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/14

3:00 p.m., February 1, 1991

R. D. Erb, Acting Chairman

Executive Directors

Alternate Executive Directors

Z. Iqbal, Temporary
L. E. N. Fernando
G. C. Noonan
Wang J., Temporary
J. M. Abbott, Temporary
J.-P. Schoder, Temporary
G. H. Spencer
A. Fanna, Temporary
A. F. Mohammed
B. A. Christiansen, Temporary
W. Laux, Temporary
P. K. Kafle, Temporary
G. Bindley-Taylor, Temporary
J.-L. Menda, Temporary
S. Rouai, Temporary
J. M. Jones, Temporary
C. J. Jarvis, Temporary
G. P. J. Hogeweg
K. Kpetigo, Temporary
M. Galán, Temporary

A. Végh

K. Ishikura, Temporary

L. Van Houtven, Secretary and Counsellor
S. W. Tenney, Assistant

Also Present

IBRD: J. B. Sokol, Latin America and the Caribbean Regional Office.
Exchange and Trade Relations Department: S. Kanesa-Thasan. Legal
Department: E. Aguirre-Carillo. Secretary's Department: R. S. Franklin.
Western Hemisphere Department: S. T. Beza, Counsellor and Director;
M. Caiola, Deputy Director; J. Ferrán, Deputy Director; J.-P. Amselle,
S. Kavar, S. P. Quin, S. Shah, S. J. Stephens, J. Thornton. Advisor to
Executive Director: L. E. Breuer. Assistants to Executive Directors:
N. A. Espenilla Jr., S. Gurumurthi, O. A. Himani, V. Kural,
G. Lindsay-Nanton, C. M. Towe.

1. DOMINICA - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with Dominica (SM/91/6, 1/4/91). They also had before them a background paper on recent economic developments in Dominica (SM/91/15, 1/23/91).

Mr. Noonan made the following statement:

My authorities recognize that Dominica's small economy and narrow export base imply a high degree of vulnerability to both economic and natural disturbances. Therefore, they are in full agreement with the staff on the importance of maintaining strict fiscal discipline, encouraging export diversification, and containing cost pressures, especially given the constraints on policy inherent in Dominica's membership in the currency union of the Eastern Caribbean states.

During 1987-89, which corresponds with the period of the three-year structural adjustment arrangement, Dominica's public finances were strengthened considerably, and its performance with respect to inflation and output growth was encouraging. Moreover, despite the strain on the external accounts, resulting from increased public sector investment and the effects of Hurricane Hugo in late 1989 on exports, the level of external debt as a share of GDP was contained, and the share of commercial debt was reduced significantly.

Economic developments in 1990 continued to be encouraging. Recovery from the effects of the hurricane was rapid: real GDP is estimated to have grown by 7 percent; the unemployment rate continued to decline; and inflation moderated further. As to the external sector, the current account deficit fell by 11 percent of GDP, and a surplus in the overall external accounts was re-established, as exports of goods and services recovered. However, there was some deterioration in the 1989/90 fiscal accounts; for the first time in several years, a substantial deficit, after grants, was recorded, and the Government was required to obtain financing from the domestic banking sector.

The overall fiscal deficits during 1989/90 and 1990/91 are expected to be temporary, as they largely reflect three factors. First, to support private sector participation in Dominica's development, my authorities have undertaken a number of large infrastructure projects. It is expected that user charges on the services provided by these investments will contribute, in the future, to the public finances. Second, after a number of years of wage restraint, irresistible pressures arose during 1990 to increase civil service salaries. The 1990/91 budget had envisaged

a 3 percent increase in salaries retroactive to the previous fiscal year, but the Government was forced, after protracted negotiations, to provide substantial additional increases. Nevertheless, my authorities remain committed to restraining the growth in current expenditure and are hopeful that annual wage increases will moderate from 1991, after the proposed job grading exercise is completed and wage bargaining legislation is enacted. Third, current revenues have declined markedly as a share of GDP. This is mainly due to the effects of the tax reform, which substantially reduced direct tax rates, so as to increase economic incentives and bolster Dominica's growth potential. In addition, tax receipts were depressed, owing to the suspension of the development levy on bananas in 1989/90 in response to Hurricane Hugo, as well as to the elimination of certain consumption taxes in anticipation of the imminent introduction of the common external tariff among members of the Caribbean Community (CARICOM).

As to the external sector, my Dominican authorities are hopeful, in view of their dependence on banana exports, that preferential access to the U.K. market for bananas will not be adversely affected by the further steps toward European integration to be completed by 1992. However, they are concerned that the uncertainty surrounding this issue may damage private sector confidence and inhibit investment. Consequently, they strongly hope that the issue will be favorably resolved with a minimum of delay. My authorities recognize the risks associated with dependence on agricultural price supports. In order to strengthen the competitive position of domestic producers, the domestic procurement price for bananas has been set, especially following the hurricane, with a view to encouraging the planting of higher yield varieties, and improving productivity.

A cornerstone of my authorities' development and export diversification strategy is the provision of an economic climate that will foster private sector investment. However, it has proved difficult to persuade farmers to undertake the risk of planting alternative export crops, given the lack of experience in marketing such crops. Therefore, my authorities are considering providing price-support mechanisms and marketing assistance where necessary. My authorities also hope that the completion of several infrastructure projects, including the construction of port facilities and a cruise ship berth, will facilitate an expansion of exports of both goods and services. Dominica's hydroelectric generating capacity is also being developed to diversify the supply of energy and reduce reliance on imported fuels.

My Dominican authorities are concerned that shortages of skilled labor may hamper the development of the tourist industry. They are also troubled by the lack of health professionals in Dominica. They fully agree with the staff's recommendation that the shortage of skilled labor should be addressed through the provision of labor-training programs. It is their hope that they will receive the donor financing needed to support this vital investment in Dominica's future.

In conclusion, my authorities wish to express their sincere appreciation to the staff for its careful analysis and objective assessment of Dominica's economic situation.

Mr. Jarvis made the following statement:

The economy of Dominica continues to perform well. Much of this good performance is due to growth in income from banana exports, but there is also encouraging growth in tourism. The authorities continue to manage the economy sensibly, and monetary policy remains in the safe hands of the Eastern Caribbean Central Bank. I am in general agreement with the staff appraisal, and I will therefore concentrate on the challenges that the Dominican authorities will face over the medium term, and possible responses to these challenges.

Dominica remains heavily dependent on the production and export of bananas to the European market, and especially to the United Kingdom, but the prospects for banana exports after 1992 remain clouded. The European community has agreed, in the context of the Lomé Convention negotiations, that traditional African, Caribbean, and Pacific suppliers should not be placed in a less favorable situation with respect to preferential access and advantages than at present. This commitment should go some way toward relieving the uncertainty that Mr. Noonan referred to in his opening statement. However, substantial uncertainties remain, not least the question of the price at which bananas for the European market will be purchased. The position will become clearer only when the European Commission has made its proposals on the detailed workings of the post-1992 regime to the European Council of Ministers, and this has not yet been done.

It should be stressed, however, that even when new arrangements are adopted, uncertainties will remain with respect to the level of income that bananas will generate for Dominica and the other Eastern Caribbean countries. Much of the increase in income for Dominica over recent years, and especially the dramatic increase in income from banana exports in 1986, is a consequence of the depreciation of the U.S. dollar--to which the Eastern

Caribbean dollar is tied--against the pound sterling, which is the currency in which banana export prices are currently denominated. Dominica has, therefore, benefited from currency fluctuations in the past, but there is no guarantee that the authorities will continue to benefit in this way. Indeed, if there is a significant appreciation of the U.S. dollar against the European currencies, it would translate into a significant loss of income for Dominica.

All of these considerations underline the need for Dominica to avoid being too dependent on banana exports for its income. The authorities are clearly conscious of this, and have in mind measures to encourage diversification in the economy. These range from agricultural pricing techniques designed to encourage the production of other crops to the undertaking of infrastructure projects designed to promote tourism and other industries. The authorities are entirely correct to encourage diversification in this way, but I have some doubts about some of the measures they have in mind.

For example, on agricultural pricing, the staff has rightly pointed out the dangers of creating distortions in production patterns. Indeed, I wonder whether this has not already happened to some extent, and in a rather perverse way. I note from the background paper on recent economic developments in Dominica that the procurement price policy for bananas in effect in 1989-90 actually shielded farmers from a fall in the export price and encouraged an increase in production levels. There must also be a danger that the authorities will raise expectations among producers and possibly incur expenditure commitments that might be difficult to contain. In the light of this consideration, I am inclined to agree with the staff that the authorities' best approach is to continue investment in expanding storage facilities and improving transport links. This commodity-neutral approach should encourage the profitability of all agricultural exports and leave the question of which ones are produced to the market.

The second area in which I have some doubts is related to infrastructure projects. There has been a significant bulge in government spending in the past two years as a result of infrastructure projects, and this has caused the Government to have recourse to domestic borrowing for the first time in a number of years. If this situation is temporary, it need not concern the authorities. However, the authorities seem to have a number of other projects in mind, including the construction of an international airport. It will be important to make sure that such projects are properly financed. One approach would be to seek external borrowing on appropriate terms; another would be to encourage private sector participation to the greatest possible

extent. The authorities ought to give serious consideration to the latter option with respect to the airport plans.

However, if the authorities cannot raise such finance, and yet feel that investment in infrastructure projects is important to their diversification efforts, they might need to give some thought to increasing revenue. I can understand their reluctance to raise direct taxes, as their concerns about the effects on incentives are well grounded. However, these concerns would not impede an increase in, say, a general consumption tax, or in utility tariffs. There might be a particular case for funding improvements in water service by an increase in water tariffs, especially if this was accompanied by an improvement in the relatively low level of metering. Finally, I urge the authorities to use some caution in the initiation of projects, particularly with respect to the airport plan, which I understand an externally funded survey undertaken a couple of years ago found to be not viable.

Generally, Dominica's prospects seem to be good. Given the uncertainties associated with the change in a regime governing banana exports and the fact that the Dominican economy is likely to be in something of a transitional stage over the next couple of years, I can support the staff's recommendation that Article IV consultations with Dominica remain on the 12-month cycle. However, the authorities should consider whether they could accept a move to a longer cycle once the immediate uncertainties have been resolved.

Mr. Abbott made the following statement:

Dominica made solid economic progress in the last half of the 1980s. Per capita GDP rose rapidly, and the level of unemployment dropped. Hurricane Hugo was a major setback in 1989, but strong growth apparently resumed in 1990. Inflation performance has been satisfactory. Disrupted production caused a price surge in 1989, but that was not repeated in 1990. A secure balance of payments position has been maintained. Exports have risen consistently, owing largely to improved productivity in banana production. Imports have risen and ebbed based on the pace of externally financed development projects. Concessional external finance has been well used and debt has been kept in alignment with GDP. Internal resources have been effectively mobilized, with both the public and private sectors contributing to a high rate of domestic savings.

In broad outline, Dominica has been following a commendable and successful development strategy, and the authorities are to be

commended for their prudent economic management. They should be encouraged to stick with an approach that has proved successful. The staff report calls attention to at least two areas where financial management seems to have slipped over the past year. Reform of corporate and personal income taxes reduced marginal tax rates, but it also reduced revenue. Simultaneously, current spending has edged up. The burden of budget control has fallen on capital expenditures and attempts to limit wage costs. Wage cost control appears to have been inadequate, since the staff reports that the authorities have agreed to both higher levels of public employment and higher than originally budgeted salary increases.

These trends are a clear departure from the patterns of fiscal management that have served Dominica very well in recent years. I encourage the authorities not to allow temporary slippages to accumulate into enduring problems. I wonder whether the staff could explain more fully the background to the income tax reductions. From the staff report and the background paper on recent economic developments in Dominica, it is not clear whether the entire tax reform effort was meant to be revenue neutral or to lower the overall tax burden.

The economy of Dominica is very small; therefore, it is not surprising that it is heavily concentrated in one commercial product, bananas. Within the limits of economic advantage, some diversification of activity would be desirable. The staff report indicates that Dominica is gradually improving its infrastructure in roads, energy, education, health, and water supply to support private sector activities. This is constructive and should be continued. However, the indication in the staff report that the authorities have been contemplating the introduction of price support mechanisms to encourage farmers to expand production of other crops is a cause for concern. Mr. Noonan's opening statement indicates that this is still the authorities' intention. I fully agree with the staff that such a proposal is ill-advised. I would encourage the Dominican authorities to seek advice from their AID donors or from other competent organizations on more effective and efficient programs to promote diversification of output.

I wonder whether the banking system could do more to support the objective of greater private sector diversity and vitality. The staff report conveys the impression that bank credit goes mainly to the public sector, to support mortgages, and to prime local names. There are no reports of credit quality problems. Local assets are illiquid, with placements offshore relied on for liquidity. Within this system, mortgages are given preference. The staff report notes several schemes designed to either channel funds into mortgages directly or to make mortgages available at

preferential rates. I fully agree with the authorities that home ownership contributes to social stability. However, I suspect they may have carried this mortgage preference policy to the point where developing private sector enterprises find very limited availability of bank credit. While the authorities say that established bank customers encounter little difficulty, this merely encourages my belief that nonestablished customers are rationed out. I wonder whether the staff could comment on this issue.

In recent years, Dominica has built an excellent track record of sound economic management. It has used the resources it has drawn from the Fund well, and its repurchase record is flawless. I encourage the authorities of Dominica to overcome some recent weaknesses and to continue on the path they have established.

Mr. Spencer made the following statement:

The Dominican economy has performed well over recent years, but, like many other small island economies, it remains vulnerable to natural disasters and to movements in a narrow range of world commodity prices. My comments relate to the sort of policy strategies that will make such an economy more resilient to external shocks.

First, as Mr. Noonan acknowledged in his opening statement, there is clearly a need to maintain an adequate financial buffer. In other words, the Dominican authorities should be very careful not to overextend the public finances in their attempts to support living standards and to further the development program. This need for fiscal conservatism is accentuated by Dominica's continuing dependence on a variable supply of foreign grant money.

The staff projections suggest that the overall fiscal deficit after grants will decline from 9 percent of GDP in 1990-91 to less than 1 percent in the next financial year. They note that this projection presumes strict limitations on capital spending and the avoidance of excessive wage increases. On both of these counts, however, recent experience does not encourage confidence that the growth in public spending will be sharply curtailed.

There still seems to be a long list of ongoing public sector investment projects, including the hydroelectric and water export developments, as well as talk of a new international airport. I wonder whether Mr. Noonan could comment on how confident he is that capital spending will indeed be cut by 7 percent of GDP in 1991-92.

With respect to the public sector wage bill, the recent large wage increases in the wake of union pressure suggest that current expenditure will also be hard to pull back.

Over the period 1985-89, ongoing real wage increases of 2-3 percent per annum in both the private and public sectors were supported by terms of trade growth and productivity gains in the private sector. However, while real national income fell in 1989, with lower commodity prices and the effects of the hurricane, real wages kept on rising. In this respect I am not sure what Mr. Noonan meant by the reference to "a number of years of wage restraint prior to 1990" contained in his opening statement.

The recent decision to halt further increases in public sector employment will clearly help to contain wage costs, but if government finances are to withstand future shocks to the Dominican economy, it is essential that wages be related to the Government's revenue base, which is, in effect, the earning power of the private sector.

I wonder whether Mr. Noonan could explain how the new measures described in his opening statement, in particular the public sector job grading exercise and the wage bargaining legislation, might help to achieve effective wage restraint.

As to the aim of increasing the resilience of the economy through export diversification, I agree with the staff as well as Mr. Jarvis and Mr. Abbott that price-support mechanisms for nonbanana crops are not the answer. Such mechanisms only distort relative price signals while placing a potentially large burden on the public finances.

As the staff suggests, a more useful approach would involve reducing obstacles to new crop development by continuing to develop the domestic infrastructure and by providing technical and market information to growers. In addition, it is important that the Government should work to ensure that the incentive structures facing producers are not biased toward banana growing.

In this respect, I agree with Mr. Jarvis that the price smoothing activities of the Dominica Banana Marketing Corporation may not be helpful. Banana growers have received very good returns over recent years in the knowledge that the risk of a market downturn has--at least partially--been covered by the central marketing authority.

In such a situation, with growers offered a full market return, but protected against market risk, we should not be too surprised to see production tending to concentrate in the highest return crop.

The banana export tax can be seen as a means to counter the bias inherent in the price smoothing mechanism, although it would seem more sensible in this case to remove the original distortion, rather than to offset it with a tax. That is to say, growers should be required to deal directly with market risk, which would give them an incentive to diversify, rather than being required to purchase an insurance policy from the Government.

However, I note from Mr. Noonan's opening statement that the banana growers may already be responding to the uncertainty surrounding the preferential U.K. market arrangement beyond 1992.

In this situation, provided the authorities did not have some inside information on the prospects for continuation of the preferential arrangement, it would seem entirely inappropriate to try to guarantee growers' incomes against a possible future downturn. In other words, a slowdown of investment and increased diversification out of banana production may well be the best strategy in current circumstances.

Therefore, it would be appropriate to remove all price-support and smoothing mechanisms--and the export tax--so that growers can make their investment decisions on the basis of full market returns and the risks facing the Dominican economy.

Mr. Menda said that the Dominican authorities' careful management of the economy was commendable, in particular given the rapid recovery in economic activity in 1990 following the damage caused by Hurricane Hugo. The fact that that recovery had been accompanied by very limited financial imbalances, despite the scarce resources of the island, was to the credit of the authorities.

He agreed with the general thrust of the staff's recommendations and that the authorities should pursue sound financial policies and avoid interfering too much in price mechanisms, even to encourage the needed diversification, Mr. Menda commented.

He agreed with other speakers that Article IV consultations with members should take into account regional aspects, Mr. Menda stated. In that connection, Dominica currently belonged to two organizations, CARICOM and the Organization of Eastern Caribbean States (OECS).

As the staff report indicated, following many years of discussion, an agreement had been reached among the members of CARICOM on a common external tariff, Mr. Menda noted. He wondered whether the staff could elaborate on the consequences of that agreement. It should be noted that, as a result of the agreement, import duties had been raised in Dominica. He wondered whether the staff could comment on the extent to which that change and its possible impact on diversification would affect Dominica.

Membership in the OECS appeared to have had quite a beneficial impact on Dominica's economy, Mr. Menda considered. For example, the common central bank had exerted a positive influence on the financial policies of its member states, which were currently engaged in discussions on increased political integration, with the final goal of establishing a federal state. He wondered whether the staff could comment on the status of those discussions and assess the economic impact of such integration.

Mr. Bindley-Taylor made the following statement:

We are pleased to note that during the 1986-89 structural adjustment arrangement, the Dominican economy experienced strong GDP growth, moderate inflation, a strengthening of domestic savings and the external sector, as well as a lower level of unemployment.

While favorable prices and good agricultural performance contributed to growth in GDP, sound fiscal policy and a pragmatic development strategy provided a receptive atmosphere for economic growth.

The strengthened fiscal position over the period 1984-88 resulted in a large reduction in net credit to the Government by commercial banks and this, together with slow growth in private sector credit and rapid expansion in broad money, led to substantial increases in the size of net imputed international reserves.

The hurricane in 1989 changed the picture. The overall public sector deficit and the external current account deficit deteriorated sharply. However, during 1991/92 the overall public sector deficit is expected to decline to 1 percent of GDP.

The medium-term prospects for Dominica are sound, but given the narrow economic base and its dependence on preferential markets, external grants, and fortuitous weather, there may be several windows of vulnerability.

We are encouraged that after years of uncertainty, there seems to be some signal from the European Community that the proposed single European market of 1992 would not alter

significantly the current preferential market arrangements of African, Caribbean, and Pacific banana exporters. Nevertheless, we urge the authorities to view this as a temporary respite and to proceed to diversify into new domestic crops for export, as well as new markets for industrial exports. Despite the relative profitability of bananas, such a shift is critical. Certain other agricultural crops can be viable if the same level of government support available to banana growers in the areas of marketing, agricultural extension programs, and better physical infrastructure were available to nonbanana growers. We agree with the staff, however, that caution should be exercised in the use of price support mechanisms to encourage exports.

Like previous speakers, we urge the authorities to use caution in moving toward diversification into tourism, as Dominica's relative advantage in this area is not at all clear. It is also off to a late start in a region dominated by competitive tourist facilities; many of its nearby competitors are presently upgrading and modernizing their facilities.

The exchange rate regime of the Eastern Caribbean states has served Dominica well, and its external competitiveness continues to be satisfactory. The relatively small manufacturing sector should therefore seize this opportunity to maximize its potential for exports, despite the limited opportunities.

Dominica's history of cautious management of the country's public finances augurs well for the future. The policy of gradually substituting concessional financing for nonconcessional financing has resulted in a falling ratio of debt and debt service to GDP. Strict control of current expenditures should continue to have a moderating effect on private sector wages and ensure competitiveness; the prudent course of matching capital expenditure to external grants should also continue.

Mr. Ishikura made the following statement:

The economic performance of Dominica was generally satisfactory in recent years, except for the setback caused by hurricane damage in 1989. Both the authorities and the staff consider that the prospects for 1991-93 are also favorable. However, these prospects are heavily dependent on exogenous factors, such as the volume of banana exports, tourism earnings, and inflows of foreign assistance and private investment.

As other Directors and the staff have noted, a main economic target for policy implementation in the coming years will be the elimination of the economy's structural fragility, which is based

on the heavy reliance on a single crop--bananas, which accounted for nearly 60 percent of the value of exports in 1990.

With respect to fiscal policies, from 1985/86 to 1988/89, the management of public finances seems to have been sound. The Government maintained surpluses in both the current account and the overall balance of the consolidated public sector. The overall balance in 1989/90, however, recorded a large deficit equivalent to 9 percent of GDP. This is mainly due to reductions in income tax rates and increased capital expenditures, owing to the launching of large projects. The authorities expect this deficit to be temporary. In his opening statement, Mr. Noonan elaborated on the prospect that the deficit will be eliminated in a relatively short time. However, we continue to have doubts about the appropriateness of the income tax reduction, particularly at a time when capital expenditures are clearly expected to increase with the implementation of development projects in the future.

Also, the insufficient restraint on wage increases adds to our concern that the overall deficit might not move close to equilibrium in line with the Government's prospects.

As to the relationship between wage increases and competitiveness, during 1985-89, annual wage increases averaged about 7 percent, which is 2-3 percentage points above the consumer price increase. Furthermore, the Government granted wage increases of 7 percent annually on average for the period 1988/89-1990/91. We welcome the measures to restrain wage increases, such as the job grading exercise and the wage bargaining legislation referred to in Mr. Noonan's opening statement. However, owing to the tightness of the labor market, wages are always exposed to upward pressures. I agree with the concerns expressed by the staff that the continued high rate of wage increases would impair external competitiveness unless there are larger productivity increases. In this connection, maneuverability in exchange rate policy is limited because of the common currency system of the Eastern Caribbean states. Therefore, the need for the authorities to take a stricter fiscal stance to restrain further wage increases, which would also send the right signal to contain private sector wages, should be emphasized. At the same time, an increase in productivity should be sought through labor training and improving the transportation system.

Mr. Hogeweg stated that he agreed with the comments of previous speakers, in particular Mr. Spencer, with respect to banana production and the need to diversify the production base.

According to the staff report, the diversification of the agricultural production base had been hampered by the relative profitability of bananas, which had diverted land and labor away from other crops and contributed to soil erosion, Mr. Hogeweg noted. Mr. Noonan had indicated that the authorities were dealing with that problem, especially following Hurricane Hugo, by setting procurement prices in a way that would encourage the planting of higher-yield varieties, but he wondered what that meant. Producer prices could be set relatively high to allow planters sufficient cash flow to invest in the production of new varieties. Alternatively, producer prices could be set relatively low, so that only the higher yield varieties would yield sufficient profit.

He suspected that procurement prices would have been set relatively high, Mr. Hogeweg commented. In that case, the crowding out of other crops would be reinforced, rather than diversification being promoted. There was also an interesting contradiction, in that connection, between concern about the future of preferential access to the United Kingdom and the wish to diversify the production base. The relatively high procurement prices could only be maintained because of that preferential access. If the authorities were serious about diversification and the adverse consequences of excessive emphasis on banana production, they should not be too concerned about preferential market access. However, it should be realized that lower banana prices and a more diversified production base might well imply lower per capita incomes.

In addition to those considerations, it had been noted in the discussion that one of the difficulties in getting farmers to produce other crops was their lack of experience in marketing those other crops, Mr. Hogeweg commented. It was likely that the effort to enhance the experience of farmers in that respect was hampered not only by the fact that those crops were new, but also by the easy, well established channels of banana marketing in the United Kingdom.

In the light of those considerations, he fully agreed with other speakers and the staff that the need for diversification should be addressed through the use of market-based approaches to the extent possible, Mr. Hogeweg stated. The preferential market access to the United Kingdom, and the relatively high procurement prices for bananas set on that basis, were not conducive to diversification.

The staff representative from the Western Hemisphere Department noted that the projected level of capital expenditure contained in the staff report was based on the development projects currently under way. The airport project had not been included in the estimates for capital expenditure, because financing had not yet been secured. The authorities had indicated that they would not begin work on the airport project unless an outside grant or highly concessional lending could be obtained for it. On the basis of the projects that were included in the investment program,

expenditure was likely to decline from the high level that had prevailed in the past two years.

The authorities considered that the reduction in income taxes would provide a significant incentive for growth, the staff representative said. Thus, the fiscal measures were not intended to be revenue neutral, but to provide a reduction in direct taxation that would encourage saving and investment in the private sector. The authorities hoped that the adverse effects on revenue would be offset through the growth of investment and its repercussions for overall growth of the economy as well as by the tight control over current spending.

The assumption that wages would grow by 6 percent annually over the next three years was justified by recent experience, the staff representative commented. As for containing employment in the public sector, the authorities considered that the recent rise was limited to essential staffing requirements in the medical services field and in the prison system.

Concerning the question of whether the banking system could play a greater role in funding private investment, it was important to note that the banks in Dominica, as in other Caribbean countries, traditionally had followed a conservative approach to lending, the staff representative stated. Preference was given to mortgages, import financing, and consumer installment credit, and it was not easy to obtain financing for more adventurous investments, which would have to carry much higher interest rates than those currently in place, unless the public sector would bear the risk. The authorities had indicated that the Agricultural and Industrial Development Bank was sufficiently funded to permit individual craftsmen to undertake investments, but it was not able to finance large-scale manufacturing endeavors.

The establishment of a common external tariff, which had been under discussion among CARICOM members for many years, was expected to be implemented during the first quarter of 1991, the staff representative continued. However, some difficulties in implementing the system had recently arisen, because a number of islands that were less oriented toward manufacturing or agriculture had expressed stronger reservations than had been expected about the level of import duties. Therefore, proposals to revise the level of the common external tariff were currently being considered. If the common external tariff was implemented as presently structured, it would imply an increase of about 15 percent in import duties for Dominica and would improve the competitiveness of its exports within the CARICOM region. In particular, such Dominican exports as soap and soap products would benefit from improved protection in the markets of Jamaica, Trinidad, and other CARICOM countries.

Intensive discussions on political unity were also under way among the members of the OECS, the staff representative went on. Although those

discussions were at a relatively more advanced stage among Dominica, St. Vincent, Grenada, and St. Lucia, actual political unity seemed to be some way off. The Prime Minister of Dominica, who was regarded as a strong supporter of political unity, had indicated that a very clear mandate, of as much as 75 percent of a popular vote, would be needed in order to move ahead with plans for unity.

While Dominica was at a disadvantage in relation to other CARICOM members with respect to traditional types of tourism, which required beaches and swimming facilities, it had a comparative advantage in alternative types of tourism, such as those offering deep-sea diving facilities and nature trails, the staff representative explained. Thus far, the Government had not taken part in the relatively large-scale private sector investments that were planned in the tourism sector. One group of private investors had invited the Government to take part in planned investments, amounting to about \$150 million, over the next three years in the tourism industry, but the Government had quite prudently declined the offer.

As Mr. Hogeweg had correctly pointed out, if Dominica did not have preferential access to the U.K. market, many banana farmers would probably withdraw from banana production, and export diversification would occur as a result of market forces, the staff representative said. However, the banana growers of Dominica were merely taking advantage of the opportunity that was currently provided by the preferential access.

The Banana Marketing Corporation was offering higher procurement prices for higher-yield varieties as a means of compensating growers for idling land while new strains were planted, the staff representative from the Western Hemisphere Department concluded. During the replanting process, existing plants had to be cut down to allow for proper spacing of the new plants and that meant that six to nine months of production was sacrificed before new production began.

Mr. Noonan said that he was grateful for the constructive comments Directors had put forward during the current discussion, in particular the call for more robust fiscal conservatism, which would be conveyed to his authorities.

The Dominican authorities were seriously concerned about the recently approved civil service wage package, which was well in excess of initial expectations and the result of extensive negotiations, Mr. Noonan stated. While the authorities were committed to wage restraint, they had come under a great deal of pressure to increase salaries. Indeed, the additional compensation provided, amounting to 7 percent, was not excessive relative to recent rates of inflation, which were 6 percent in 1989 and 3 percent in 1990 prior to the oil crisis. In the light of Dominica's vulnerability to the loss of skilled labor through migration to North American countries and neighboring islands, the authorities considered that by differentiating

between grades and trades, the pay policy could be adjusted in favor of those who were most likely to leave Dominica for jobs in other countries.

While most countries tried to diversify their exports on the basis of natural advantage, Dominica was afflicted by national disadvantages, Mr. Noonan commented. As a small volcanic peak with extremely rough terrain, agricultural production of any sort was difficult in Dominica. Dominica did have a comparative advantage for environmental tourism, and the indications for private sector investment in that sector were encouraging. However, new positions in that sector were not expected to offset the job requirements of the resident population.

In the light of the lack of marketing experience in all other crops aside from bananas, it was extremely difficult to encourage diversification of the agricultural production base, because it was essentially asking the population to set aside a fairly well established product to invest in the production of crops, the marketing of which was perceived to be much more uncertain, Mr. Noonan continued. Therefore, bananas were likely to remain a very important crop for Dominica.

Both the Dominican authorities and the farmers were reassured by the European Community's commitment that in the creation of the new rules to govern trade in bananas after 1991, traditional African, Caribbean, and Pacific suppliers should not be in a less favorable situation than in the past or the present, Mr. Noonan went on. However, uncertainties still arose with respect to the means that could be used to access European markets without paying the common external tariff. For example, bananas could be imported to European markets through Germany free of the common external tariff. While the European Community was trying to find a solution to that problem, there was also pressure from consumer groups within the European Community to lessen preferential access to the U.K. market.

In the light of those considerations, if diversification efforts were left to the market, small holders, who had no resources to cope with fluctuations in the market, could not be expected to experiment in crops for which there might not be a market, Mr. Noonan said.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the appraisal contained in the staff report and commended the authorities for the satisfactory performance of Dominica's economy since 1985, evidenced by the relatively high rates of growth of real GDP, the drop in the unemployment rate, the low inflation rate, and the strengthening of the public finances. Directors were pleased with the fast recovery from the effects of Hurricane Hugo in September 1989, but noted that this had quickly been followed by a narrowing of the public sector's current account surplus and a widening of the overall deficit, which led to

borrowing from commercial banks after several years of net repayments. Directors also commented that although the external current account deficit had narrowed in 1990 with the recovery of banana exports, it was still sizable in relation to GDP. They noted that the manufacturing sector had experienced setbacks caused by rising labor costs, and expressed concern regarding the recent increase in public sector wages.

Directors remarked that Dominica's production and export base remains narrow, partly reflecting the stimulus to banana production provided by favorable prices in the U.K. market, and they drew attention to the uncertainties regarding the post-1992 regime for banana exports to the European Community. They supported the authorities' efforts to expand and diversify production and exports, particularly through policies aimed at improving the infrastructure and promoting private sector initiatives, but cautioned against the establishment of price support mechanisms to achieve these objectives. Directors noted that prospective private sector investments would expand tourist accommodations and increase manufacturing capacity.

Directors expressed the hope that the completion of the large public investment projects under way would permit a sharp reduction in the overall fiscal deficit, thereby eliminating the need for further domestic bank borrowing. They urged the authorities to limit future public capital expenditure to the amount funded from public saving and external concessional financing. Directors also stressed the importance of restraining the growth of public sector wages, so as not to adversely affect Dominica's competitiveness and external payments position. Directors added that, if necessary, the authorities should consider raising additional current revenue through increasing the general sales tax. They emphasized the need to monitor closely developments in costs and

productivity, and supported the continuation of investment in labor training programs in order to address the present shortage of skills and increase labor productivity.

Directors noted that membership in the currency union of Eastern Caribbean states had served Dominica well.

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

APPROVED: October 2, 1991

JOSEPH W. LANG, JR.
Acting Secretary