0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/161

10:00 a.m., November 27, 1991

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	A. Raza, Temporary
Che P.	
	G. Lindsay-Nanton, Temporary
	J. M. Abbott, Temporary
	F. Moss, Temporary
E. A. Evans	N. A. Espenilla, Jr., Temporary
	B. Bossone, Temporary
M. Finaish	A. F. Mohammed
	A. Gronn, Temporary
	S. Shimizu, Temporary
	S. von Stenglin, Temporary
J. E. Ismael	
	F. A. Quirós, Temporary
	P. Bonzom, Temporary
A. Mirakhor	M. A. Hammoudi, Temporary
L. B. Monyake	
	P. Wright
	Z. Trbojevic
	N. Toé, Temporary
	M. Da Costa, Temporary
	L. E. Breuer, Temporary

L. Van Houtven, Secretary and Counsellor
C. P. Clarke, Assistant

Also Present

Central Asia Department: M. W. Bell. Exchange and Trade Relations Department: H. M. Al-Atrash, S. Kanesa-Thasan. Legal Department: J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; A. H. Al Yousuf, S. H. Hitti, M. D. Knight, J. Martelino, S. M. Tareq, C. A. Yandle, M. Yaqub. Secretary's Department: A. Jbili. Southeast Asia and Pacific Department: L. M. Koenig, Deputy Director; R. C. Baban, T. T. Do. Advisors to Executive Directors: M. B. Chatah, S. K. Fayyad, B. R. Fuleihan, M. Galán, Y.-H. Lee, M. J. Mojarrad, M. Nakagawa, A. M. Tanase. Assistants to Executive Directors: T. S. Allouba, J. H. Brits, A. Giustiniani, S. Gurumurthi, P. K. Kafle, W. Laux, Y.-H. Lee, R. K. W. Powell, S. Rouai, C. M. Towe.

1. LEBANON - REPORT BY DEPUTY MANAGING DIRECTOR

The Deputy Managing Director said that the World Bank was convening an aid coordination meeting for Lebanon in Paris on December 12-13, 1991, and a number of countries, Arab Funds, and international organizations had been invited to attend. The Fund would be represented by a senior staff member from the Middle Eastern Department. The main purpose of the meeting was to discuss the strategy for the reconstruction of the country, which would include issues relating to priorities for financial and technical assistance. In addition, the meeting would work to encourage the participating countries and institutions to consider providing foreign aid to Lebanon. For the purpose of the meeting, a World Bank team had visited Beirut in early November, and a small Fund staff team had visited Beirut from November 14 to November 22 to assess the situation in such areas as the budget, monetary developments, the balance of payments, and exchange rate policy. The staff's assessment would be presented to the Paris meeting in a document drafted jointly with the World Bank, as well as in a statement by the Fund representative at the meeting. The Fund would endeavor to extend technical assistance to Lebanon in banking sector reform, improving the fiscal system, and the design of a macroeconomic framework of adjustment, including the needed supporting policies. He asked Executive Directors to convey to their authorities the importance that the Fund attached to the serious efforts to place Lebanon on a path to economic recovery.

Mr. Al-Tuwaijri remarked that he welcomed the Fund's involvement in the efforts to assist Lebanon. After 15 years of destruction, Lebanon deserved the help it was receiving from all regions of the world. He hoped that the Fund would extend all possible assistance in restructuring the Lebanese economy.

Mr. Finaish commented that his Lebanese authorities had asked him to express their appreciation for the Fund's support of Lebanon's reconstruction process. As was well known, the authorities had always valued the Fund's assessments and advice on macroeconomic matters, which would be particularly important during the reconstruction phase. He was pleased to hear the Deputy Managing Director's affirmation of the Fund's readiness to extend technical assistance to Lebanon, particularly in the fiscal and monetary areas. The authorities had made specific requests for such assistance, and he hoped that the current pressures on the technical assistance departments would not cause delays in meeting those requests. Clearly, after 15 years of war, Lebanon's reconstruction needs were enormous. Nevertheless, he was optimistic that Lebanon, supported by its many friends, including multilateral institutions such as the Fund and the World Bank, would be able to recover physically and economically. There were many inherent strengths in the Lebanese economy, but, in order to tap those strengths fully, the basic infrastructure had to be restored. Of course, that could not be done without external help, and he was certain that all the friends of Lebanon, whether in the region or in other regions, were aware of those issues.

2. SOCIALIST PEOPLE'S LIBYAN ARAB JAMAHIRIYA - 1991 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1991 Article IV consultation with the Socialist People's Libyan Arab Jamahiriya (SM/91/213, 10/31/91). They also had before them a background paper on recent economic developments in the Socialist People's Libyan Arab Jamahiriya (SM/91/217, 11/12/91; and Cor. 1, 11/26/91).

Mr. Finaish made the following statement:

> A long-standing objective of economic policy in Libya has been to increase the country's growth potential through broad-based development of the oil and non-oil sectors, taking into account social priorities and objectives. While this strategy continued through the 1980s, the sharp decline in oil export revenue during the latter part of the decade necessitated policy adjustments to prevent the emergence of domestic and external imbalances. The authorities' financial prudence was reflected in the external reserves position, which remained strong, despite temporary declines that were quickly reversed.
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> Given the country's limited resource endowment outside the hydrocarbon sector, and recognizing that oil revenue will play a vital role for the foreseeable future, the authorities have attempted to follow a long-term approach to exploration, production, and domestic pricing of petroleum products. They have also engaged in downstream investments to secure outlets for crude oil production and have expanded the petrochemical industry, in which Libya has a clear comparative advantage. The potential for further growth in petrochemical exports will depend on accessibility of markets, and the authorities hope that this sector's potential will not be hindered by trade barriers in Libya's traditional markets.
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> Beginning in 1987, in an effort to accelerate and broaden the development process, steps were taken to encourage private sector participation in economic activity. To this end, a number of liberalization measures have been adopted. Noteworthy among these were the opening up of borders with neighboring countries, the easing of price controls in agriculture, and greater incentives to promote private investment while simultaneously transferring more than 100 state enterprises to workers' cooperatives. These measures, combined with the large investment in infrastructure that had been made in earlier years, contributed to the favorable non-oil growth performance, which averaged about 4 percent annually in 1989-90. In the case of agriculture, performance was especially strong, with annual growth averaging 9 percent over the past five years. Indeed, the medium-term outlook for agriculture

is potentially quite promising in the light of the Great Man-made River (GMR) project, which should allow a substantial expansion of cultivable land.

Financial developments in Libya during the 1980s were dominated by the decline in oil export revenue, particularly in the period 1985-88, which reflected international market developments. In order to safeguard the country's financial position, the authorities responded to the sharp drop in revenue by reducing public sector expenditure--current as well as capital--substantially, and also by restraining imports. The continued freeze on civil service salaries and on new hiring is illustrative of the authorities' tight expenditure policy. This policy was continued in FY 1989/90 despite the recovery in oil revenue. Supplementary outlays--mainly on defense and subsidies--were also reduced substantially. In 1990/91, the fiscal deficit increased somewhat as a result of increased capital spending in industry and agriculture.

The 1991/92 budget envisages a substantial reduction in the fiscal deficit. This will be achieved through across-the-board cuts in spending. In addition, a number of non-oil revenue measures are being considered in the areas of income taxes, agricultural activity, stamp duties, and fees for GMR financing. Moreover, the budget foresees a larger role for the private sector in education and health services.

Reflecting the policy of expenditure restraint, the impact on the balance of payments of the sharp decline in exports was mitigated substantially. While external reserves have fluctuated somewhat since the mid-1980s, they have remained relatively comfortable. The steps taken toward trade liberalization have led to an increase in imports in the past two years. However, this was more than offset by the recovery in oil exports. Thus, in the period 1980-90, Libya's trade surplus increased significantly, and the overall balance of payments position recorded a large surplus after being in deficit since 1986. The authorities expect the external position to be broadly balanced in 1991.

The medium-term balance of payments scenario constructed by the staff attempts to show the implications for the current account of a particular set of assumptions regarding trade and services flows. Clearly, such an exercise is limited by the high degree of uncertainty, particularly with regard to oil revenue but also in estimating the supply response to the ongoing liberalization process. Moreover, the authorities consider the staff's projections of imports and services payments to be on the high side, as, in their opinion, the recent venting of pent-up demand for imports and travel is unlikely to continue at the same level.

On the whole, the authorities expect the external position to be roughly in balance over the medium term. However, in the event that the external position comes under pressure, the authorities will act promptly, as they have done in the past, to safeguard the external reserves position. With the liberalization of the trade regime, the containment of imports would need to be brought about by tightening demand management instead of resorting to administrative controls, which seems to be the staff's main concern. Whether exchange rate flexibility would be a necessary component of such a policy response is open to question, although, as mentioned by the staff, the authorities have an open mind on this issue and will keep the merits of the various options open to them under review.

Finally, the authorities wish to reiterate their disappointment at the continuation of the freeze imposed on Libya's assets by the U.S. Government since January 1986, as well as the recent extension of U.S. restrictions against Libyan concerns. The Libyan authorities continue to believe that the U.S. actions have serious implications for international financial relations and should be of serious concern to the international community, and to the Fund in particular.

Mr. Mirakhor made the following statement:

As evidenced by the staff report and Mr. Finaish's helpful statement, Libya continues to make progress in its adjustment efforts. Since 1985, substantial progress has been made in redressing domestic and external imbalances. In the real sector, the authorities' policies of diversifying the country's production base and enhancing private sector involvement in the economy, as well as the relaxation of price controls, have led to impressive growth in the agricultural sector, with an average growth rate of 9 percent a year between 1985 and 1990. More important, this encouraging supply response has resulted in a reduction of the share of food items in total imports, from 18 percent in 1986 to 9 percent in 1989. Along with the authorities' policy initiatives, the completion of the GMR project could have a great impact on the agricultural sector as well as other areas of the Libyan economy. In this regard, I wonder whether either Mr. Finaish or the staff could give us any further information on the overall impact of this project on the economy.

Even though the agricultural sector's supply response to policy measures is impressive, the industrial sector's performance is no less significant, as it reacted to policy initiatives with a growth rate of 12 percent annually in 1985-90. As a result, the share of this sector in non-oil GDP has increased by 3 percent.

As both the staff report and Mr. Finaish's statement indicate, the authorities are committed to continued liberalization policies in the real sector, enhanced by privatization efforts. More than 100 state-owned light manufacturing enterprises have already been privatized, and the authorities are encouraging the transfer of ownership of more public enterprises as well as redeploying public sector employees to the productive sectors.

In the fiscal area, the authorities have maintained a tight expenditure policy. Between 1985 and 1989, total expenditures were reduced by 33 percent, and, although spending increased somewhat in 1990, the overall level of spending in 1991/92 is budgeted to be 28 percent less than its level in 1985. Whereas administrative expenditure is projected to increase by 15 percent in 1991/92 compared with 1985, development expenditure is budgeted to decline by 57 percent relative to 1985. It appears from the explanation given on page 22 of the background paper that, along with this substantial cut in the magnitude of development expenditure, there is also a qualitative redeployment of these expenditures to more productive sectors--that is, agriculture and industry. I would appreciate staff comments on this observation. More significantly, supplemental expenditures in 1991/92 are budgeted to be only 50 percent of its 1985 level. According to the explanation on page 21 of the background paper, this item, which has been on a continuous decline since 1986, includes military expenditures and subsidies as well as other items. I would appreciate it if the staff could provide some additional explanations of the "other items" included in supplemental expenditures and of the percentage of military spending in those expenditures. If military spending constitutes most, or even a significant portion, of the supplementary expenditures, then this represents a very significant development, as it indicates a major reduction in military spending by Libya.

In the external sector, the authorities have taken firm steps toward trade liberalization, which, along with the oil export recovery, has led to a large surplus in the overall balance of payments position in 1989-90. According to Mr. Finaish, the authorities expect that the balance of payments will remain broadly balanced in 1991. Over the medium term, the export of non-oil products is expected to gain momentum, and, in this regard, market access--particularly for products in which Libya enjoys a clear comparative advantage--becomes very important, as is the case with other countries with substantial opportunities in petrochemical products. I wonder whether Mr. Finaish or the staff could provide some information on the impact of protectionist policies on export promotion in Libya.

With regard to the medium-term scenario, I would be interested in the staff's response to the comments made by Mr. Finaish in his statement regarding the assumptions underlying the scenario as well as the import and service payments projections. Moreover, in relation to the staff's recommendation on exchange rate policy, I would appreciate learning from the staff whether it has a particular view on policy sequencing. Undoubtedly, there is validity in the authorities' concern that exchange rate flexibility cannot have more than a marginal impact on export earnings, especially before the domestic economy is significantly liberalized. Of course, the staff is fully cognizant of the fact that exchange rate action alone--that is, without "an adequate macroeconomic framework and price sensitivity as well as transmissions unhindered by controls"--would not achieve the desired result, but it is not clear whether the staff is advocating the so-called big bang solution or a more sequenced approach that would allow the present policy initiative to gain strength and momentum while allowing the exchange rate to reflect its scarcity cost.

It appears that the strategy of the authorities has been to stabilize the economy and sequence reforms by liberalizing the domestic economy more rapidly than the external sector, leaving exchange rate reform to a more appropriate time. There may be greater advantage in a reform process that is stronger in magnitude with a more rapid pace. In that case, the concern would be, as seems to be the case with the staff's argument on page 15 of the staff report, that with an expected reduction in foreign exchange earnings and a projected increase in imports, external reserves may come under too much pressure. I certainly appreciate the care with which the staff expresses its recommendation. My understanding of the relevant passage on page 15 is that what the staff is recommending in the present Libyan context is appropriate pricing of foreign exchange to reasonably reflect its scarcity cost. This, of course, need not necessarily mean an exchange rate determined in the free market. I would appreciate being corrected if I have misunderstood the staff's views.

On an issue that is of interest to my constituency, I missed seeing any reference in the report to the Arab Maghreb Union (AMU). I would appreciate hearing either from Mr. Finaish or the staff on the implication for the Libyan economy of the establishment of the AMU. With these remarks, we support the proposed decision.

Mr. Al-Tuwaijri made the following statement:

During the latter half of the 1980s, the Libyan economy, like all oil exporting economies, was faced with falling international oil prices, which had an adverse impact on public finances and the external payments position. The authorities responded with severe expenditure cuts and a compression of imports; hence, they were able to avoid resorting to external borrowing. As a result of this consolidation, the fiscal deficit narrowed from over 20 percent of GDP in 1986 to an estimated 3 percent of GDP in 1989/90. More significantly, starting in 1987, the Libyan authorities have taken positive steps to encourage wider private sector participation in the economy.

As I am in general agreement with the staff's appraisal, I will make only a few comments for emphasis. In the move toward a more market-oriented economy, the Libyan authorities have embarked on a program of transformation favoring productive activities with a greater role for private initiative. As mentioned in Mr. Finaish's helpful statement, these welcome measures include the opening up of foreign trade, encouragement of the participation of private partnerships and cooperatives in agriculture, manufacturing, and retail activities, relaxation of the regulations governing travel abroad, and the opening up of borders with neighboring countries. In light of the positive effects of these measures on the rate of growth of the non-oil sector, the authorities are encouraged to continue their efforts and to expand the scope of their structural reform, in order to enhance economic efficiency and promote the diversification of the economy's productive base. In this regard, the development of a flexible pricing system and a dynamic and market-based financial system will not only help the efficient mobilization and allocation of national savings but will also open up greater opportunities for private investment.

On the external sector, the high rate of growth in the non-oil sector and the expanding productive base of the economy are expected to increase imports and service payments. This may result in a loss of reserves, thus jeopardizing the reform momentum. However, it is encouraging to note that the authorities have an open mind on the question of exchange rate adjustment.

Regarding the oil sector, I welcome the authorities' commitment to the stability of the oil market, and I share their concern about the restrictions imposed by some European countries on imports of petrochemicals. Such restrictions will protect industries that have lost their comparative advantage as well as stifle the efforts of the oil producing countries to diversify their economies and to realize their comparative advantage.

Finally, the improvement in the balance of payments and budget positions in 1990 and the projected 5 percent growth in GDP in 1991 augur well for the Government's efforts to intensify the economic reform process and move toward a more market-oriented economy.

With these remarks, I support the proposed decision.

Mr. Moss made the following statement:

I would like to organize my observations on the Libyan economy under three headings: issues related to the oil sector, elements pertaining to the non-oil sector, and policy questions.

With regard to the oil sector, it is no exaggeration to state that this sector will remain the dominant force of the productive base, given the extent of both oil and gas reserves in terms of years of production at current output levels. In all likelihood, engaging in downstream activities such as refining and petrochemicals corresponds, therefore, to developing the natural comparative advantage of the country. While the staff appraisal focuses mainly on developments in the non-oil sector, the staff report does mention the policy of expanding the country's refining capacity abroad, whereas for petrochemical production, it is indicated that marketing abroad might become more difficult in the future, even though, as is highlighted in the background paper, the country's petrochemical production has a comparative advantage over other Middle Eastern producers owing to its proximity to European markets. Mr. Finaish's statement deals with this very topic, and Mr. Mirakhor has also turned to it in his own statement.

Recalling our recent discussion on world trade issues, a scenario under which Libya would be faced with trade diversion--whereby its comparative advantage in petrochemicals production was eroded as a result of, say, an arrangement between the EC and the Gulf Cooperation Council--is not altogether unrealistic. Has the staff already discussed these issues with the authorities, or have the authorities themselves given thought to the idea of pursuing a strategy for petrochemicals similar to that they have embarked on with regard to refining--that is, to acquire production facilities within traditional export markets?

As a second observation regarding oil issues, I was somehow puzzled by two seemingly contradictory findings. In the staff report, mention was made of a staff suggestion to adjust domestic prices of petroleum products in order to restrain domestic demand, which has been on the rise since 1986 and which probably will continue to rise if the development of the non-oil sector progresses as intended. While I would subscribe fully to such a suggestion, bearing in mind that domestic prices of oil have remained largely unchanged since 1983, I was struck by a sentence on page 7 of the background paper, which stated that, with the exception of fuel oil and kerosene, domestic product prices currently exceed international market prices. It is not my intention to open a debate on issues in energy pricing policy, for which we will have another occasion, but I would welcome staff clarification of how these two findings can be reconciled.

Turning briefly to the non-oil sector, I had only one question, which pertains to the potentially promising outlook for agriculture. As Mr. Mirakhor has already raised the issue, however, I need not go into it now.

Regarding economic policies, my third item, I, like Mr. Al-Tuwaijri, welcome the greater role accorded to private initiative in the Libyan economy. Like the staff, I agree that this policy cannot but go hand-in-hand with greater decontrol of the economy. At the same time, such decontrol will involve more careful monitoring by the authorities of economic developments in order for them to map out adequate policies. In other words, the need for more accurate data is evident. I commend the steps already taken or decided upon by the authorities in this respect, such as the new household expenditure survey to be conducted this year to serve as a basis for a revised price index, as well as the decision to incorporate and detail all accounts in the budget document starting in 1991/92. I would urge the authorities to continue in this direction, particularly with a view to resolving the substantial discrepancies between the fiscal and monetary accounts. Given the growing reliance of the private sector on bank credit, monetary data will become increasingly important.

The same underlying developments, continued expansion in the non-oil sector and increased private participation in economic activity, will, of course, put more and more pressure on the control mechanisms governing domestic economic activity. The staff report deals extensively with the external elements of such pressures. It points to the fact that the elimination of border controls has lead to leakages in the system of exchange and trade controls and has "opened up opportunities for arbitrage activities." While it is only natural for an institution such as the Fund to stress such external elements with regard to a country that continues to impose restrictions on its exchange system, I would have liked a more forceful elaboration of the internal consequences of the controls.

In particular, the cost of further adherence to a policy of unchanged interest rates and continued price controls could have been highlighted further by stressing that it would fail to elicit the supply response in the private non-oil sector that the authorities are expecting. If, under these circumstances, pressures start to build on the demand side, the results will be suppressed inflation and rationing internally, while, externally, the demand for foreign exchange will go up and, in the wake of controls, a widening spread between the official and the unofficial exchange rate will emerge. I have the impression that the debate on a more appropriate pricing of foreign exchange has been focused too narrowly on the level of reserves in a medium-term perspective, putting too much emphasis on the uncertain projections for oil prices and, therefore, oil export earnings. The staff appraisal recognizes, of course, that exchange rate adjustment would be useless unless accompanied by an adequate macroeconomic framework and price sensitivity, as well as by transmissions unhindered by controls. Putting the focus more on the latter elements could have highlighted more clearly the plausibility of the staff's medium-term import and service payments projections, thereby vindicating its medium-term scenario from the internal, rather than the external, side.

An additional but important argument for urging the Libyan authorities to continue introducing market mechanisms in their effort to be successful in increasing nontraditional output and in raising efficiency standards is the fact that three of Libya's major Arab neighbors, to whom the Jamahiriya has opened its borders--Algeria, Tunisia, and Egypt--have all embarked on a similar route under Fund guidance. Focusing exclusively on the exchange rate now entails the risk of insufficient attention being given to domestic policy issues, which would be unfortunate, as this Board will only have an occasion to review the Libyan economy in two years from now. Meanwhile, this chair supports the proposed decision.

The staff representative from the Middle Eastern Department recalled that Directors had expressed some interest in the GMR project and its impact on the economy. The information that had been made available to the staff, which was contained in the staff report and the background paper, indicated that the first part of the project, which was concentrated in the eastern part of the country, had been inaugurated in August 1991. The first part of the project was expected to add between 180,000 and 200,000 hectares of irrigated land and would facilitate more extensive supplies of water resources to the agricultural areas in the eastern province; of course, part of those resources would be used for domestic consumption, possibly including the industrial sector.

The two statements in the staff papers to which Mr. Moss had referred--that there had not been an adjustment in domestic prices of petroleum products for a long time, and that calculations using official exchange rates suggested that domestic prices were more or less in line with international prices--were not necessarily contradictory, the staff representative considered. If the relevant calculation was based only on current official exchange rates, of course, an increase in domestic prices would mean some additional taxation of petroleum products. However, it should be noted that the official exchange rate was substantially overvalued, and, if a more realistic rate was used, some domestic prices might be below the international equivalent. On the question of protection abroad against imports of Libyan petrochemicals, the authorities felt that they were not at present handicapped by that practice, given Libya's competitiveness and its advantageous position, although they had voiced some concern about the future, as was noted in the staff report. The staff had no information about plans by the authorities to develop petroleum production facilities abroad.

With respect to the questions raised by Mr. Mirakhor about the composition of supplementary expenditures, the staff representative continued, it was the staff's understanding that those expenditures were comprised predominantly of military expenditures. The staff did know whether all military expenditures were included under the category of supplementary expenditures, nor was it aware of the other components of that category. The data that had been provided to the staff on the composition of expenditures included a specific number only for subsidies, which were included as supplementary expenditures and which had grown significantly in the past year. Nevertheless, based on the information with which it had been provided, the staff had drawn the tentative conclusion that military spending had decreased substantially, given the apparent decline in supplementary expenditures.

The main theme of most of Mr. Mirakhor's questions, however, seemed to revolve around exchange rate policy, the staff representative said. The relevant statement on exchange rate policy in the staff report was on page 13: "...to avoid the risk of having to revert to a policy of restricting access to foreign exchange, greater flexibility in the exchange rate policy for a period of time would be needed, supported by comprehensive policies including measures to contain domestic demand and realistic pricing of credit and commodities." That statement suggested that the staff's advice to the authorities had not been framed in terms of moving in one big step toward a new exchange rate, but that a flexible path should be pursued in a pragmatic way toward finding a new and appropriate level for the exchange rate. One had to remember that Libya had a command-type economy, with strict foreign exchange budgeting for imports, for over 20 years. The restrictions on access to foreign exchange had always been a feature of the Libyan economy, and the disparities in prices made it difficult to derive a single model with which to arrive at an appropriate exchange rate in one move.

With respect to the assumptions underlying the staff's medium-term scenario for the balance of payments, the projected increase in imports reflected the extent to which the authorities allowed demand to rise, given that the system of foreign exchange budgeting for imports had not been relaxed sufficiently to allow demand to be reflected fully, the staff representative from the Middle Eastern Department commented. The staff had taken a restrained view on the growth of imports and had assumed a growth of about 10 percent, compared with more than 12 percent during the previous three years. Similarly, the assumptions underlying the projection for services also reflected past considerations. Of course, the staff's assumptions were consistent with the expressed hope that the authorities would not respond to a diminution of foreign reserves by reverting to further restrictions.

Mr. Wright considered that the pattern of revenues and expenditures for the GMR that were presented on page 53 of the background paper looked extremely odd; it suggested that revenue had actually fallen since 1984 to the point at which, in annualized terms, 1991 revenue was about one third of the level in 1984. Moreover, the project had been making a profit until 1987, which also seemed odd to him in light of the information presented by the staff.

The staff representative from the Middle Eastern Department replied that he would not characterize the project itself as having made either a profit or a loss. The financing for the project had been predicated on the implementation of certain revenue measures and on the making of the necessary investment expenditures, as well as recourse to the banking system of about LD 600 million. Of course, in the period before any expenditures had been undertaken, there had been a surplus in the so-called earmarked financing items that were to be collected for the purpose of that project. The GMR's fiscal accounts were independent of the Treasury accounts. It was true that the collection of receipts that were supposed to have been earmarked for the GMR seemed to have experienced some weakness over time, and the authorities had acknowledged that they were having difficulty in collecting those receipts. As noted in the background paper, in order to strengthen the collection of revenues, the authorities had decided to take additional measures for the financing of the GMR.

Mr. Abbott remarked that, as Mr. Moss had mentioned, the statistical base clearly needed to be improved for effective public sector management. The staff had noted some progress in that area, but the comments on page 10 of the staff report indicated that a great deal more needed to be done in both proper classification of accounts and timely recording of information. The IFS data were incomplete and badly out of date. From the various staff documents, it seemed clear that the consultation had suffered from the inadequacy of available data. While that inadequacy was an inconvenience for the Board's deliberations, it was surely a more basic problem for the authorities. He would encourage the authorities to devote further effort to improving their statistical resources.

He agreed with the staff's observation that maintaining widespread restrictions was inconsistent with the liberalization measures undertaken so far, Mr. Abbott said. In fact, much of the staff report gave the impression that the authorities were not clear in their own mind about the development strategy they wished to follow; that impression was reinforced by the comments of the staff representative. Liberalization and enhanced private sector involvement were repeated themes, but it was hard to identify a coherent framework for translating those themes into a general policy. Mr. Mirakhor had broached that issue when he had inquired about the sequencing of reforms and whether the staff was recommending a big bang approach to deregulation. Beyond the questions of sequencing and pace, however, he wondered how well prepared the Libyan authorities were to proceed with the development approach they had begun.

Mr. Toé made the following statement:

> We welcome this opportunity to discuss recent economic and financial developments in Libya. We support the proposed decision.
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> It is encouraging to note that the non-oil sector of the economy continued to respond favorably to the authorities' program aimed at encouraging private sector participation in economic activities. This favorable development is evidenced by the robust and broad-based real growth in non-oil GDP recorded in 1989 and 1990, with contributions from the agricultural, manufacturing, and utilities and other services sectors. Although recent developments in the fiscal sector could be a cause for concern, the Libyan authorities deserve commendation for the magnitude of their fiscal adjustment in the face of shrinking oil revenues. Indeed, they have succeeded in reducing the overall fiscal deficit from an average of 17 percent of GDP for the period 1985-88 to only 3 percent of GDP in 1989/90. Moreover, the external position is estimated to have strengthened substantially in 1990, with the overall balance of payments registering a surplus of about $2 billion, following four years of successive deficits.
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> There is not much that I can add to the comments already made by previous speakers, and, as I am in broad agreement with the staff appraisal, I will make a only few remarks for emphasis on the fiscal sector and statistical issues.
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> First, with respect to the fiscal sector, we share the staff's concern about the sharp deterioration in the fiscal position in 1990/91 in spite of the substantial improvement in government revenue resulting from windfall oil revenues. However, our concern is allayed by the fact that this deterioration stemmed largely from increased development outlays. More importantly, we are reassured by the statement made by the Libyan authorities to

the staff that the sharp increase in government outlays in 1990/91 did not signal a change in their fiscal policy stance and that they will continue to pursue a prudent expenditure policy. In this respect, we note that the 1991/92 budget contemplates a significant reduction in the overall deficit through cuts in all categories of expenditure--administrative, development, and supplemental. Like the staff, we would urge the authorities to implement the non-oil revenue-raising measures under consideration and to exercise strict expenditure controls in order to achieve the budget target.

Still on the fiscal sector, the shift in the composition of expenditures away from defense spending and outlays on subsidies is noteworthy. We welcome the steps taken to present the 1991/92 budget in a more comprehensive framework, bringing into the budgetary process all revenues and capital expenditures and the financing items. Nevertheless, as mentioned by the staff, much remains to be done to clarify the fiscal accounts, as the lack of up-to-date information hampers an adequate analysis of fiscal developments.

This brings me to my second point. It ought to be recognized that since the last Article IV consultation with Libya on October 23, 1989 (EBM/89/136), progress has been made in improving the economy's statistical base. This is borne out by the more comprehensive budgetary framework adopted for 1991/92 and the meaningful presentation of balance of payments data. It appears that the technical assistance provided by the Fund has played a role in bringing about this noticeable improvement. The monetary accounts, which were analyzed by the March 1991 Fund technical assistance mission, could similarly benefit if the staff's recommendations were implemented. Generally, we would encourage the Libyan authorities to avail themselves of all possible technical assistance in order to continue to improve the quality and timeliness of the statistical data.

Finally, we take note of the Libyan authorities' commitment to contribute to the stability of the oil market and their increased financial assistance, in the form of loans, to other countries.

Mr. Trbojevic made the following statement:

I would like to start by complimenting the staff on being able to prepare its informative report while lacking adequate statistical data. It is to be hoped that the current massive assistance to the U.S.S.R. will not discourage Libya from seeking further technical assistance from international organizations, especially in the areas of national accounts and public finance.

Leaving aside fiscal policies and the external situation, on which the staff gives adequate analyses and policy recommendations, I want to confine my comments to what is probably the main challenge that Libya faces: to transform the economy in a way consistent with both internal needs and the changed international environment.

According to the staff report and Mr. Finaish's statement, some positive developments can be perceived. I welcome the wider participation of private entities in economic activity and the partial opening up of the economy to foreign trade. However, the authorities' approach seems to me somewhat half-hearted; the limited attention Mr. Finaish pays to the reforms in his statement strengthens my view. Development of private initiative in the non-oil sector is fostered, but in a manner that, in my opinion, will not lead to a flourishing and viable private sector.

First of all, many regulations and price controls appear to be maintained. This, of course, implies that an essential part of the competitive market, the price mechanism, is missing. Market participants will respond to distorted signals and resources will be allocated inefficiently. An efficient producer will not be able to increase his market share by cutting prices. Therefore, the dynamic process that brings about overall economic efficiency is not in place, but I hope it will be in the near future. Furthermore, private activity is stimulated by offering cheap capital and other forms of subsidies. An initial financial stimulus can certainly be helpful to get private activity going. However, one runs the great risk of creating enterprises that are permanently dependent on government assistance and that might not be able to operate in a genuinely competitive environment.

In brief, I am afraid that the current changes in the Libyan economy are incomplete and that, therefore, the economy will not benefit from them to the extent possible, especially not in the long run. Having said this, I would like to stress the need for further deregulation of the economic activities in Libya and encourage the authorities to continue more vigorously the process of introducing and implementing more comprehensive policies in the economy.

Compared with many other countries discussed in the Board, Libya is in a privileged position. The oil revenues give the country the opportunity to invest in its future, without having to forgo current consumption. With these remarks, I support the proposed, regrettably repetitive, decision.

The staff representative from the Middle Eastern Department said that the staff was not aware of a well-developed plan for proceeding with the existing reforms or a more comprehensive package of reforms. There seemed to be a sense among some officials that such a plan would, in principle, be useful, but that view did not at present appear to be shared by the Government.

Mr. Finaish remarked that the GMR water project, which was extremely important for Libya, had received a great deal of attention in the press. The project, which began in 1984 and would cost about $25 billion, was an attempt to move underground water from the south of the country to the coastal area, where a majority of the population lived. There had always been a water problem in the country, but it had recently become extremely serious, and much depended on the project. In the early 1970s, owing to the lack of water, the Government began to move the population to the south where there was water, but the experiment had not been terribly successful, and the GMR project was intended to move water to the population.

Inevitably, such a project would face problems in both design and implementation, and there were, of course, some who were critical of the project because of the many uncertainties, Mr. Finaish said. For example, some critics wondered whether the project was not merely another so-called white elephant. In the authorities view, however, they had no choice in the matter, as the country needed the water. Moreover, they saw the project as a possible blueprint for others in the area, particularly as the technology employed in the project was relatively simple. Essentially, the project aimed to take water from underground reservoirs and move it in huge concrete pipelines across the desert. Some had wondered whether there was enough groundwater in the country to justify an investment of about $25 billion. When the Government began the project, it had commissioned many international firms to study the proposal. According to some firms, at a minimum, there was enough water for between 50 and 100 years, although that projection did not take into account either recycling or rain fall; other firms had come to the conclusion that there was probably enough water for hundreds of years at the expected rate of use. With respect to the ability of the pipelines to endure the heat of the desert, the Government and experts were convinced that they could.

Noting that the water would basically be used for three purposes--agriculture, industry, and domestic use--some critics had expressed the concern that most of the water would be used for domestic consumption and that there might not be enough water left for agriculture, Mr. Finaish recalled. Another criticism was that the Government should first try alternative, more conventional techniques, such as desalination. However, desalination was more expensive and could not, therefore, be used in agriculture. According to the available studies, the unit cost for water shipped from abroad was about $2.75, while the unit cost for desalinated water was between $2.85 and $3. The corresponding cost for water conveyed through the GMR project was only $0.24 per unit. With respect to the possible environmental implications of the project for the country's neighbors, all studies carried out in Libya and abroad had concluded that the water supply was well protected. In any event, the volume of water was enormous.

The first stage of the project, which had cost more than $4 billion, had been completed and had made it possible to move water from oases in the desert to the coastal area around Bengazi, Mr. Finaish stated. Of course, the money that was being spent on the water project was not being spent on other things, including the hydrocarbon sector exploration. There was also a need for technical personnel, and the country was already trying to address that issue. It had also been argued that the project would represent a burden on the use of oil revenues and that it would be cheaper to import food produced in neighboring countries than to import labor from those countries to support the Libyan agricultural sector. However, the authorities had studied the problem very carefully. The project had been designed in such a way that, in the event of technical problems or a shortfall in financing, it could probably be stopped after the completion of the second stage, which was due to begin shortly. More generally, however, it had to be understood that, in Libya, the imperative of securing a reliable source of water was a strong one.

The AMU, to which Mr. Mirakhor had referred, had been established in February 1989 and comprised Algeria, Morocco, Mauritania, Tunisia, and Libya, Mr. Finaish said. The first meeting of the heads of state of the AMU had been in January 1990. The AMU was interesting in that it was a purely economic exercise. In the past, many attempts at regional integration had been undertaken with an explicitly political motivation, but the AMU was an economic institution, inspired by the European Economic Community and concern about the implications for the North African countries of the single European market in 1992 and developments in Eastern Europe. Europe was the most important market for the North African countries; only about 1-2 percent of Libya's trade was with Arab countries, and its main trade partners were in Europe. As was noted in the background paper, over the past five or six years, about 78 percent of Libya's trade was with Europe, 25 percent of which was with Italy alone, and 95 percent of Libyan exports went to Europe, 48 percent of which went to Italy. The United States had been an important trading partner for Libya, but since 1982 that situation had changed. Understandably, therefore, the motivation behind the establishment of the AMU was the concern about developments that were taking place to the north of the AMU countries and the prospects for the region's exports to the north.

The economies of the countries comprising the AMU were highly complementary, Mr. Finaish remarked. For example, Algeria had a heavy industrial base, energy, and a deficiency in food; Morocco had processing capabilities and a surplus of food; while Libya had an abundance of energy. The AMU would provide its member countries with access to a larger market and increased economies of scale. They could pool their expertise and work toward the free movement of labor and capital. It was also interesting to note that four of the five countries--that is, all but Libya--had Fund programs in place. Therefore, all five countries were in some way committed to economic liberalization. Much of the AMU machinery for economic cooperation already existed. There was a Council of Heads of State, which was convened every six months and had already met at least three times; a parliament, or Consultative Council, in which each of the five countries was represented; and technical committees for certain issues, such as finance and food. An agreement had been reached on the establishment of a customs union by 1995, and decisions had been made on the establishment of a regional airline, a court, and an academy of science. Joint ventures were already taking place between member countries. For example, Libya was cooperating with Tunisia in the exploration of oil, with Algeria in certain gas line projects, and with Mauritania in iron ore upgrading. The relations between Libya and Egypt had also progressed in a substantive way, as was evidenced by the agreements that had been reached between the two countries in the fields of industry, agriculture, electricity, and the free movement of labor. Therefore, in addition to the liberalization effort inside Libya, there was also an opening up of the Libyan economy to other countries in the area.

In analyzing the long-term outlook for the Libyan economy, as mentioned by some speakers, one had to bear in mind the fact that the country did not have a debt problem, Mr. Finaish said. Libya was a small developing country, which had achieved independence in 1951. In the area of military spending, the country had already taken some unilateral actions, reflected in the decline in supplementary expenditures, which were basically for defense. Furthermore, for the past two years, the Government had been encouraging members of the armed forces to enter the productive sectors of the economy--agriculture and industry--through a scheme that offered leave without pay from the armed forces for one year. Notwithstanding the positive features of the Libyan economy, however, the country's resource endowment made it difficult to diversify. The Government was trying to address that issue through the GMR water project--which, it was hoped, would be helpful to agriculture and industry--and by opening up the economy to neighboring countries.

A few speakers had wondered whether the pace of reform was sufficient or whether the scope of reform was comprehensive enough, Mr. Finaish recalled. While those concerns were understandable, it was also important to have a good understanding of the authorities' concerns in that connection. First, it had to be recognized that the private sector had not participated in the economy for the past two decades, which was an almost unique experience among developing countries. The institutional and structural features of the economy made it difficult for market forces to begin to operate effectively overnight. The authorities felt that it was reasonable, given the situation, to follow a gradual approach, which, in their view, would minimize the disruption that was usually associated with sharp structural changes. That being said, one should not underestimate the extent of the policy shift in Libya, which the staff appraisal had called "basic." While the changes had, perhaps, been modest compared with those in other countries, they represented fundamental changes in the Libyan context, given the situation over the past two decades.

Second, Mr. Finaish continued, the authorities remained cautious about the pace of reform owing to their concern about the external position. The source of that concern was the experience of the oil-exporting countries in the 1980s, when Libya's oil income declined from about $20 billion to $5 billion. Obviously, the authorities could not control that market, but the economy relied almost exclusively on that single item. In response to external pressures, the authorities had been very successful in reducing the domestic absorptive capacity, although it was true that they had achieved that mainly through administrative measures. There was no doubt that if the need arose for further action to protect the external position, the authorities would do whatever was necessary. Therefore, in their view, it would be better to move cautiously and deliberately in the reform process rather than thrust ahead at the risk of having to move backward if an external imbalance were to emerge. Nevertheless, he did not disagree with the views of the staff and a number of speakers that the process of change had to be broad based, as action in one area might not be fully effective unless positive feedbacks were allowed to operate in the economy. The authorities' pricing and exchange rate policies and the institutional reform had to be approached simultaneously.

In recent years, Libya, like Kuwait, had been trying to find foreign outlets for its crude oil and petrochemical production through the purchase of downstream facilities in Europe, Mr. Finaish stated. At present, Libya had downstream facilities in Germany and Italy, composed basically of refineries and gas stations, and negotiations were under way with Belgium, Germany, Greece, Italy, and Spain for additional capacity. Over one fifth of Libyan production--both crude and petrochemical--was being exported through those facilities. He was not aware of plans to invest in other industries abroad.

There had been an improvement in the quality of economic data maintained by the Libyan authorities, Mr. Finaish commented. The authorities had taken seriously, and had made good use of, all the technical assistance that had been provided to them. As the staff had noted in its report, they had implemented many of the staff's recommendations, particularly in the balance of payments and monetary areas but also in the fiscal area. Like any other country, however, there was always room for improvement.

Finally, in recent months, many committees, with the participation of Libyan expatriates, had been studying a framework for a comprehensive plan for the authorities' reform efforts, Mr. Finaish said.

The Acting Chairman made the following summing up:

Directors were in general agreement with the thrust of the staff appraisal contained in the staff report for the 1991 Article IV consultation with the Socialist People's Libyan Arab Jamahiriya. They noted the recent initiatives to encourage private participation in economic activity and that these initiatives have helped to revive growth in the economy. The impressive supply response of the agricultural sector was welcomed, and it was observed that the completion of the first phase of a major irrigation scheme was expected to contribute significantly to economic expansion in the country. While commending the authorities for the steps taken so far, Directors called for a speeding up of the reform process. The extensive controls applied on the economy still impeded market signals and thus contributed to a misallocation of resources, and Directors therefore urged a greater relaxation of these controls. Such a structural approach would need to be underpinned by comprehensive macroeconomic policies.

Directors noted that the fiscal deficit had been reduced substantially during the second half of the 1980s, owing mainly to the exercise of restraint on spending. While development expenditures had been reduced considerably, Directors welcomed in particular the significant reductions in administrative and supplementary expenditures, the latter category consisting essentially of spending on defense. In 1990/91, however, the very considerable rise in oil revenues was more than matched by a large increase in public spending, which led to a widening of the deficit. With oil revenues projected to stabilize in the future, Directors were of the view that it would be important to revert to a cautious expenditure policy. In this connection, they welcomed the decision to meter and collect charges on water that will be distributed from the Great Man-made River project, and they encouraged the authorities to implement other non-oil revenue measures that had been put forward in the 1991/92 budget.

The strong performance of the oil sector in 1990 allowed a large increase in imports of goods and services as well as a significant building up of reserves. Directors welcomed the closer and more open economic relationship with neighboring countries and the improved access to foreign exchange by private individuals. The point was also made that the authorities should seek to clarify their development strategy and accelerate the pace of reform. With regard to the medium-term balance of payments prospects, in the event of a weakening of oil receipts, it was important that the authorities implement macroeconomic policies of restraint, together with a more determined strategy of reducing administrative controls, including those related to prices, investment, and access to foreign exchange. In those circumstances, it would also be necessary to follow an appropriate exchange rate policy, with further reductions in controls on imports and foreign exchange and private activities more generally.

In sum, Libya's efforts to strengthen the development process and give a broader role to private initiatives were steps in the right direction, but they should be broadened and consolidated so that the economy and the general welfare of the country might reap the full benefits of the measures already adopted. Directors also urged the authorities to give priority to improving further the economic and financial statistics.

It is expected that the next Article IV consultation with the Socialist People's Libyan Arab Jamahiriya will be completed within 24 months of the completion of the 1991 Article IV consultation.

The Executive Board then took the following decision:

1. The Fund takes this decision relating to exchange measures of the Socialist People's Libyan Arab Jamahiriya subject to Article VIII, Sections 2(a) and 3, and in concluding the 1991 Article XIV consultation with the Socialist People's Libyan Arab Jamahiriya, in the light of the 1991 Article IV consultation with the Socialist People's Libyan Arab Jamahiriya conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Socialist People's Libyan Arab Jamahiriya continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV, except for the multiple currency practice and exchange restrictions, as described in SM/91/217, that are subject to Fund approval under Article VIII, Sections 2(a) and 3. The Fund urges the authorities to liberalize the exchange system and to eliminate the multiple currency practice as soon as possible.

Decision No. 9865-(91/161), adopted
November 27, 1991

3. KIRIBATI - 1991 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1991 Article IV consultation with Kiribati (SM/91/212, 10/29/91). They also had before them a background paper on recent economic developments in Kiribati (SM/91/220, 11/13/91).

Mr. Evans made the following statement:

My Kiribati authorities wish to thank the staff for the rewarding discussions that took place in Tarawa in August 1991. My authorities see the annual visit of the Fund mission as a useful opportunity for exchanging economic information and views on domestic policies. They found the staff report to be a well-balanced assessment of recent developments and consider the staff appraisal to be broadly consistent with the current direction of economic policy.

Domestic economic growth in Kiribati has been minimal in recent years, reflecting the policy constraints on public sector growth and disruptions to export production and markets. Although the staff report does not present data for GNP growth--which would be useful in future reports--it is likely that this would have been noticeably stronger than that of GDP, given the size and growth of foreign source income accruing to Kiribati financial intermediaries.

The Kiribati economy exhibits some unusual features for a low-income developing country, not the least of which is a sizable and continuing current account surplus and consequent transfer of real savings abroad. This is facilitated by the Revenue Equalization Reserve Fund (RERF) and the policy decision to invest its assets abroad in the light of "the dearth of domestic investment instruments and the availability of higher yields abroad." The other domestic financial intermediaries pursue similar investment strategies. This investment strategy has served Kiribati well, in terms of isolating national income and, hence, domestic consumption--both public and private--from frequent swings in the terms of trade and in export production. At the same time, however, domestic infrastructure and business investment needs--in fishing, for example--remain unsatisfied, suggesting an implicit assumption that the returns to such investments are inadequate. Successive Article IV consultations have endorsed that assumption and, hence, the authorities' investment strategy. These matters should be kept under review to ensure that opportunities for domestic investment and, hence, development are not overlooked.

My authorities appreciate the technical assistance that has been provided by the Fund and hope that such assistance will continue to be available as appropriate.

Mr. Abbott remarked that financial management in Kiribati was unquestionably excellent. The country's external reserves equalled more than seven years of import cover and were growing in real per capita terms, the external current account was consistently in surplus, and the budget was tightly controlled and securely financed. Development spending was financed almost exclusively with foreign aid, and borrowing was limited to concessional loans from abroad. Debt service was about 1 percent of exports.

Kiribati's sterling financial record had not been matched by equivalent domestic economic success, Mr. Abbott noted. The development plan for 1987-91 set an unambitious goal for annual real growth of 2.1 percent, just enough to maintain real per capita income. That modest goal had not been achieved. Fairly or unfairly, the staff report conveyed the impression of an economy that was being run down. Fish production had suffered because fleets had not been maintained. Copra production was handicapped by aging trees. Investors reportedly saw few opportunities for rewarding projects.

In Mr. Evans's statement, there was just the slightest suggestion that, perhaps, it would be appropriate for the Board to question, rather than endorse, the investment strategy Kiribati had followed, Mr. Abbott commented. In his view, that was a suggestion worth pursuing. As Mr. Evans had indicated, the implicit assumption seemed to be that returns to real investment in Kiribati were not equal to the returns on financial investment abroad. Hence, the transfer of real savings abroad was justified. Certainly, that would be a prudent course for a company in a secularly declining industry that wanted to set itself on a course for long-term liquidation; it was not obvious, however, that that was a prudent course for an economy with a rapidly growing population and an annual GDP per capita of less than US$600. Surely more could be done to identify or to improve the productivity of internal investment. He would be interested in any further thoughts the staff had on that subject.

The staff report indicated that the Kiribati authorities intended, for the present, to continue to use the Australian dollar rather than introduce a currency of their own, but that that issue would be kept under review, Mr. Abbott noted. The current arrangement worked well. Introducing and maintaining a separate currency was a resource-using activity. For a country as small and underdeveloped as Kiribati, it was difficult to see any economic gains that would outweigh the costs from having a separate currency. In his view, a separate currency should be discouraged.

Mr. Trbojevic made the following statement:

Let me say at the beginning that it is remarkable that even a small, low-income developing country such as Kiribati has been able to perform quite well in the last two years. Its achievements appear more impressive if analyzed in the context of an adverse external environment determined by the decline in external prices for its main exports. I cannot refrain from mentioning that, perhaps, Kiribati's most important asset was and continues to be a tradition of prudent economic management. The authorities should be commended for that. Kiribati's total external assets and external reserves prove that implementation of sound economic policies by the authorities, with timely external financial support, can produce economic stability, even if the external environment is not favorable.

The level of subsidies in Kiribati's economy declined steadily over the last four years; as a matter of fact, by the end of this year they will represent only 0.6 percent of GDP. However, almost 40 percent of the total amount of subsidies estimated for 1991 will be directed to Telecom Kiribati, the company that in August-September 1990 reduced the charges for international direct dialing by 30 percent. The second part of the total amount of subsidies will be for public utilities. Although the financial position of public enterprises in Kiribati has improved within the last few years, I agree with the staff that "further progress is needed to place them on firm financial footing."

There are some key public enterprises, such as Te Mautari Ltd., which are still prone to losses. Viable operations in this and other enterprises require that they be converted to private management and ownership. There are many ways to encourage that process, and joint ventures and selling shares are two of them. The more aggressive privatization program introduced by the authorities might start the process in areas like fishing and shipping. The authorities should be encouraged to develop further the privatization program and to implement it in order to increase the efficiency of enterprises and to decrease direct financial support and subsidization.

Although the Kiribati authorities are determined to continue maintaining prudent financial policies through 1991 and 1992, the economy remains vulnerable to external shocks. With that in mind, I support the opinion of the staff that the policy priority of the authorities should be protection of the country's external reserves, especially through strengthening of the management and performance of the RERF, the largest part of the country's external assets.

Finally, let me ask for some clarification from the staff about Table 4 of the background paper, which presents GDP by economic activity. It surprised me somewhat that the contribution of government administration--including education and health--in the formation of GDP at market prices, which for 1991 was projected at 28 percent, is almost the same as that of agriculture, fishing, transport, and communication as a whole. If the methodology used is a problem, perhaps technical assistance in the area of national accounts is needed from international organizations.

With these observations, I support the proposed decision.

Mr. Wright said that he endorsed the staff report and commended the authorities for their continued fiscal restraint in spite of the difficult external circumstances. Despite the recent fall in exports, the current account--including transfers--remained in substantial surplus, and the RERF continued to grow. It was clear from the staff papers that economic development in Kiribati was, to a very large extent, circumscribed by the country's remoteness and physical characteristics, and he was fully mindful of those facts in making his comments.

Like other speakers, Mr. Wright continued, he would be interested to learn from the staff whether it saw any scope for further diversification of the Kiribati economy--in the tourism sector, for example. The opportunities for diversification seemed to be limited, but it was hard not to detect some sense from the staff report that the impetus to investment and development might be blunted somewhat by the existence of an--otherwise welcome--cushion of income from the RERF. Mr. Evans had pointed out in his statement that domestic infrastructure and business investment needs sometimes remained unsatisfied--as evidenced, for example, by the deterioration of the fishing fleet--and there was an implicit assumption that returns on such investment were inadequate compared with those available elsewhere. Like Mr. Abbott, he had a sense from the staff papers that the economy was not going anywhere, and he wondered whether there was any scope for the World Bank to identify suitable projects to finance in what was a well-managed, low-income developing country. On another point, it was his understanding that there was a long-standing prohibition against the purchase of land by nonnationals in Kiribati. He wondered whether that policy acted as a significant extra inhibition to direct investment.

He agreed with the staff that public sector prices needed to be kept under review, Mr. Wright remarked. In particular, tariffs should be adjusted to ensure full recovery of costs without cross-subsidization. He endorsed the staff's recommendation that a degree of competition should be introduced into the management of the RERF through the use of a second fund manager, possibly from a different financial center. Such advice was, of course, prudent in a general sense but was especially so given the scope that existed to manage the portfolio in a manner that was more flexible but, at the same time, prone to greater short-term volatility of returns. In that connection, he wondered whether transactions costs in the past had been at competitive levels, given Kiribati's long-standing relationship with the existing fund manager.

He also agreed with the staff that interest rates should be more flexible, Mr. Wright stated. He wondered why, in a country that used the Australian dollar as its currency, interest rates had so far managed to avoid regular adjustment. He assumed that the solution to that puzzle was a function of distance and communication. Nevertheless, he was concerned about the recent unstable interest rate structure of the Kiribati Provident Fund, to which the staff had drawn attention, and he wondered whether there was any mechanism to prevent a recurrence of a similar pattern in the future. Finally, the staff had said that it was appropriate for Kiribati to continue its use of the Australian dollar "for the time being." Like Mr. Abbott, he found it difficult to conceive of the circumstances in which the staff might think that it would be appropriate to discontinue that arrangement.

Mr. Bonzom said that he fully agreed with the conclusions of the staff report. The authorities should be commended for having continued their prudent strategy, even in the wake of the adverse exogenous developments experienced in 1990, when real GDP fell by almost 9 percent. That cautious stance had been particularly noticeable in the fiscal area and in the approach to external borrowing. Such a policy was encouraged by the exchange arrangement and was made necessary by the vulnerability of Kiribati's main sources of foreign earnings. Obviously, that caution had not been without rewards: inflation had been kept at a low level and the current account balance showed a healthy surplus of 29 percent in 1991. In a longer-term perspective, it was encouraging to note that agricultural exports had recently been diversified to include seaweed products and that new savings patterns were beginning to take hold among the population.

On fiscal policy, he agreed with the staff that current expenditures should be kept under close control, Mr. Bonzom continued, especially in view of their possible increase from 44 percent of GDP in 1990 to 52 percent in 1991. If continued, such a trend could weaken Kiribati's ability to meet the challenges raised by the increased obsolescence of capital in a number of industries, such as fishing and agriculture, as well as the rise in urban unemployment and poverty. Useful steps had been taken, most notably the steady decline in direct subsidies from almost 3 percent of GDP in 1988 to 0.6 percent of GDP in 1991. Nevertheless, he agreed with the staff that further progress was necessary, particularly in the management of public firms.

The measures taken since the 1989 audit to strengthen the authorities' monitoring of the RERF's management were welcome, Mr. Bonzom considered, and, like Mr. Wright, he supported the staff's suggestions for further improvement, which would be especially useful given that the portfolio had become more vulnerable owing to the increased proportion of equities. He wholeheartedly agreed with the strategy that was aimed at increasing the real per capita value of the RERF; indeed, such a strategy had been advocated by the Board two years previously. He wondered, however, whether that strategy could not allow a little more room for maneuver. In particular, he wondered whether the RERF could not be used, within strict and obvious limits, in a more countercyclical manner. In that context, he noted that the lowest drawdown from the RERF since 1986 had taken place in 1990, when Kiribati's economy had been particularly hard hit by developments affecting its exports earnings. The staff's comments on that point would be welcome.

Mr. Shimizu stated that he supported the thrust of the staff appraisal. For the past few years, Kiribati's economic conditions had been deteriorating. In 1990, a drop in copra production and fishing yields had not only reduced GDP by 9 percentage points but had also caused a deterioration in the trade balance. In 1991, the economy had continued to stagnate and exports had declined further. More generally, Kiribati had suffered from poor land, a shortage of skilled labor, inadequate infrastructure, and remoteness from world markets. Under the circumstances, it was commendable and encouraging that one of the smallest members of the Fund had followed sound macroeconomic policies and maintained a strong balance of payments position.

As there was little room for maneuver in monetary policy, fiscal policy should be at the center of macroeconomic management, Mr. Shimizu considered. The authorities should be commended for their conservative fiscal policy, in particular for having used the one-time increase in revenue to accumulate savings in the RERF in 1991. As a result, the budget surplus in 1991 was estimated to be about 30 percent of GDP. He joined the staff in welcoming the authorities' intention to continue the prudent fiscal policy in 1992. In addition, the authorities had financed development expenditures through external aid, mainly grants. In light of the suggestion in Mr. Evans's statement that returns to domestic investment were low, such a policy was prudent. However, given the importance of development expenditures to Kiribati--particularly in the areas of social and business infrastructure and human capital--for improving the welfare of the people and increasing the country's long-term growth potential, he wondered whether development expenditures should not be financed by the public sector as well as through external aid.

Kiribati used the Australian dollar as its domestic currency rather than issuing its own currency, Mr. Shimizu noted. The Australian dollar acted as an anchor for the economy, keeping prices in Kiribati relatively stable. Moreover, given the small scale of the economy, having its own currency might be too costly for Kiribati. Therefore, like other Directors, he endorsed the authorities' intention to continue to use the Australian dollar as the domestic currency.

The authorities should be commended for having maintained the real value of the RERF through cautious management and by avoiding heavy drawdowns, Mr. Shimizu said. The RERF had stabilized the external position of Kiribati. Earnings from the RERF amounted to one third of imports. Total reserves, owing largely to the RERF, were equal to eight years of imports. The measures taken to evaluate the performance of the RERF more carefully were welcome. The authorities' target of maintaining the real per capita value of the RERF seemed appropriate and was welcome. In addition, like other speakers, he supported the staff's recommendation that a second fund manager be selected to diversify the risk to the RERF, which was so important to Kiribati.

Ms. Lindsay-Nanton remarked that she joined other Directors in congratulating the Kiribati authorities on their continued good economic management over the past two years, notwithstanding the setbacks experienced in GDP and export earnings in 1990. In the face of sharp declines in the production and export of copra and fish, the economy was characterized by a favorable external current account, strong fiscal performance, and growing external reserves.

It was clear from Table 2 of the staff report that central government finances in Kiribati were heavily dependent on income derived from the RERF as well as on concessional external assistance, Ms. Lindsay-Nanton observed. In view of that fact, she concurred with the staff and other Directors that continued restraint in fiscal policy, as well as prudent investment of the RERF, should be pursued in order to ensure good fiscal performance. As regards the rest of the public sector, the generally increased operational efficiency of most of the nonfinancial public enterprises, and consequent reduction of central government subsidies to less than 1 percent of GDP in 1990-91, was commendable. She agreed with the staff that further efforts should be made to streamline operations of other entities that were not currently operating efficiently.

The staff report noted that the performance review completed earlier in 1991 had demonstrated that the RERF continued to be reasonably well managed under the established guidelines, Ms. Lindsay-Nanton said. In fact, the real per capita value of the RERF had been increasing over the past several years, and a further rise was projected in 1991. Interestingly, as the staff report pointed out, a major shift had taken place in the structure of the RERF over the past two years, with a larger equity component, representing about 38 percent of the Fund. While a number of other measures had been introduced to improve the management of the RERF, she agreed with the staff, as well as Mr. Wright and other Directors, that improved performance and reduction of risk might be realized if a portion of the Fund was managed by a second reputable manager.

The recent decision by the Japanese authorities to cosponsor, through the United Nations, a ban on drift net fishing might have adverse short-term implications for supply in the Japanese market as well as other markets, Ms. Lindsay-Nanton considered. At the same time, it was clear from Mr. Evans's statement that returns on investment in such areas as fishing were inadequate. She wondered whether the staff or Mr. Evans considered that development of Kiribati's fishing industry might become more attractive as a result of the ban on drift net fishing.

Mr. Hammoudi said that he endorsed the staff appraisal and commended the authorities for their prudent economic policies, especially in the financial sector. Nevertheless, the authorities should increase capital expenditures in order to develop the social infrastructure in cooperation with the World Bank and other development institutions. In the same vein, economic infrastructures should also be viewed by the authorities as a priority in order to revamp and rehabilitate the fishing sector, as well as to promote investment in tourism. In that regard, the authorities would be well advised to introduce incentives to encourage investors. Furthermore, efforts to develop the agricultural sector should be pursued. It was also essential that the authorities continue the modernization of the financial sector. Efficiency in managing the public sector should be the authorities' main goal.

The staff representative from the Central Asia Department remarked that a striking feature of Kiribati's GDP was the very high degree of employment and value added that were concentrated in the public administration sector. That feature reflected the fact that the provision of basic services was one of the top priorities of the Government. In comparing the structure of the national accounts with the structure of employment in the economy, it was evident that the two were very similar, as about one third of each was derived from the public administration sector. It was true that, in analyzing Kiribati's economic data, the staff was often faced with difficulties in obtaining a clear picture of the individual elements of certain aggregates; indeed, those difficulties affected not only the national accounts but most areas of economic statistics as well, which indicated that there could be a need for technical assistance in many areas of statistical compilation.

In considering the degree of interest rate inflexibility in Kiribati, it was useful to distinguish three classes of interest rates, the staff representative said. The first class comprised deposit rates for large deposits, which had proven to be very flexible and had followed closely developments in the Australian markets. The other two classes--small deposits and lending rates--had proven to be almost totally inflexible. The small deposits were small not only in terms of absolute size but also in terms of their relative importance in the Bank of Kiribati's portfolio. The Bank had been able to absorb the costs that might have arisen from maintaining a certain inflexibility in those rates through its strategy of investing abroad. The authorities tended to defend the structure of interest rates by noting that they were aiming for simplicity; they often talked in terms of having stable and transparent rates that were available to the small investor and the small depositor. They also cited the fact that many depositors were scattered over a huge area of the Pacific Ocean and that communication was very difficult. Therefore, frequent changes in interest rates were not easy to implement.

The prohibition of land purchases by non-nationals as a constraint to investment, and, therefore, development had not been discussed with the authorities during the recent staff mission, the staff representative stated. There was remarkably little land in Kiribati, and the population density in South Tarawa Island was very high, which might help to explain the reluctance to see land passing to non-nationals. As to the potential for tourism, Tarawa Atoll, which was quite remote from most potential tourism markets, would have to use Fiji or, perhaps, one of the smaller Pacific islands as a staging post. Of course, those countries were themselves attempting to stimulate tourism and tended to capture any potential market. As for Christmas Island, which was about 2,500 miles east of Tarawa Atoll, it was far more accessible to Hawaii than Tarawa; indeed, a small specialized tourism market had already developed there. One of the key issues for Kiribati, of course, was transportation, which was currently tenuous at best.

Investment in Kiribati had been concentrated on infrastructure projects, which reflected the evident need to develop both the economic and social infrastructure, the staff representative said. It also reflected the nature and source of financing--almost exclusively aid--that Kiribati had chosen to help develop its infrastructure. There seemed to be a ready supply of aid to fulfill Kiribati's infrastructure needs; indeed, the impediment to further development was often the limited absorptive capacity of the country owing to nonfinancial variables, such as the lack of skilled labor and management and the many transportation difficulties. The authorities had begun to follow a second strategy over the past two or three years, which aimed to place greater emphasis on the private sector. However, the domestic private sector was extremely limited in terms of both its saving capacity and its managerial capacity. The attempts to redevelop the country's fishing company had recently begun to focus on the foreign private sector, an approach that could, perhaps, be helpful for a number of other enterprises and projects. Foreign investment in Kiribati was made difficult less because of low rates of return than because of the lack of local managerial expertise.

In his statement, Mr. Evans seemed to question--albeit implicitly--whether the concentration of domestic financial savings in the Bank of Kiribati, the Provident Fund, and the RERF could--and should--be diverted to domestic investment, the staff representative commented. Certainly, both the Provident Fund and the Bank of Kiribati looked for domestic opportunities for investment, but those opportunities were relatively few and far between. The Government had been reluctant to put its own resources--that is, resources generated by the Reserve Fund--into investment of a productive nature, as it tended to view such investment as the responsibility of the private sector. That view had to be seen in the light of the Government's recent tentative moves toward attracting private sector participation in various sectors of the economy; it also helped to explain the Government's reluctance to use the RERF for countercyclical purposes.

In their search for investment projects, the authorities relied heavily on external technical assistance, which had essentially been provided through bilateral aid, the staff representative said. In financial terms, the World Bank had been inactive in Kiribati. Indeed, it had not yet undertaken any lending operations, perhaps because the scale of such an operation in Kiribati would be such that it might not be consistent with the Bank's own financial objectives. The Asian Development Bank had been rather more active. It had four or five projects in Kiribati at present and was helping to identify potential areas for further productive investment.

As some speakers had surmised, there was, indeed, a certain amount of short-term pessimism with respect to the prospects for the traditional export sector, the staff representative stated. That pessimism about the prospects for copra and fishing exports, however, had been substantially offset by optimism about the prospects for seaweed exports, given the encouraging and rapid takeoff in seaweed production that Kiribati had recently enjoyed. The authorities were keen to find ways of expanding seaweed production and exports, but they were also interested in identifying--perhaps with the technical assistance of bilateral and international agencies--other commodities with similar characteristics, particularly those with low capital intensity and low transport costs. On the implications for Kiribati of the ban on drift net fishing, it should be noted that Kiribati's traditional fishing techniques did not involve the use of drift nets, which suggested that Kiribati could potentially benefit from the ban. Assuming that the ban on drift net fishing remained in force, foreign investors might, in the months and years ahead, be looking to tap the expertise of countries like Kiribati that still practiced traditional forms of fishing.

The staff was entirely in accord with the comments made by speakers on the need to maintain the Australian dollar as Kiribati's currency, the staff representative from the Central Asia Department remarked. The use of the phrase "for the time being" in the staff report could, indeed, be taken to convey the message that, in a long-term sense, there were at present no particularly compelling reasons to suggest anything other than maintaining the link with the Australian dollar.

Mr. Evans said that he, too, agreed with speakers' comments about the need for Kiribati to maintain the Australian dollar as its currency. Given the size of the economy, there was no alternative except, perhaps, a more stable currency.

On the lack of domestic financing of investment for infrastructure and business needs, the point that he had tried to make in his statement was that there might be some scope for questioning the Fund's traditional policy advice on issues like privatization and subsidies in the rather unusual case of Kiribati. As a rule, he accepted the Fund's advice on those issues on the first reading, but in Kiribati there were enormous constraints to the process of privatization, which had been suggested as the answer to its development problems. One must also wonder how a foreign investor would judge the prospects for investment in Kiribati when even the Kiribati people themselves, through the RERF, the Provident Fund, and the only commercial bank, were investing their savings abroad. Those issues would have to be addressed in any effort to establish the conditions for privatization and to attract foreign investment. They were not, however, strictly speaking, issues of immediate relevance to the Fund; rather, they were a matter for the development banks. Although the Asian Development Bank had taken some interest in the matter, there was also scope for the World Bank to become involved.

The Acting Chairman made the following summing up:

Directors commended the authorities' steady implementation of prudent economic policies. Despite the fragility of the export sector and the economy's vulnerability to external shocks, sound macroeconomic policies and, in particular, fiscal restraint have resulted in sustained external current account surpluses and reserve accumulation.

Noting continued progress in reducing subsidies to public enterprises, Directors considered that a further strengthening of the financial position of these enterprises could contribute to renewed economic growth. The authorities were thus encouraged to keep public sector prices under frequent review; the objective should be to ensure full cost recovery without cross-subsidization. Directors also cited the gains that could be achieved through a program of privatization; not only could operational efficiency be improved, but privatization might also facilitate the renovation of enterprises' capital stock.

Directors observed that the sound performance of the Reserve Fund over the past decade had allowed marked growth in its assets in real per capita terms. Directors welcomed the steps to evaluate and strengthen the management of the Reserve Fund; in that connection, they encouraged the authorities to examine the possibility of investing gradually a portion of the Reserve Fund's income under a second manager, possibly in a different financial center. They also noted that, for the foreseeable future, Kiribati would remain heavily dependent on external aid, including technical assistance.

Directors were of the view that, in Kiribati's circumstances, the continued use of the Australian dollar as the domestic currency was appropriate, as it provides an efficient and effective anchor for domestic economic policy. The authorities were also encouraged to keep the structure of domestic interest rates under regular review to ensure that they remain aligned with appropriate offshore rates.

Directors raised questions about the long-term future of Kiribati's economy. The narrow resource base and the physical remoteness of the economy were major constraints. However, Directors had the impression that the impetus for domestic investment was lacking and that domestic opportunities, such as in the fishing sector, had not been completely exhausted. They believed that the World Bank and the Asian Development Bank could play an important role in examining Kiribati's scope for development and in examining the opportunities for domestic investment.

In light of the temporary changes in Article IV consultation cycles, it is expected that the next Article IV consultation with Kiribati will be completed within 24 months of the completion of the 1991 Article IV consultation.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/91/160 (11/25/91) and EBM/91/161 (11/27/91).

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 91/61 through 91/64 are approved.

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/91/279 (11/22/91) is approved.

APPROVED: May 21, 1992

LEO VAN HOUTVEN
Secretary