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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/83

10:00 a.m., May 30, 1990

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	L. E. N. Fernando
	C. Enoch
C. S. Clark	G. C. Noonan
Dai Q.	
T. C. Dawson	B. S. Newman, Temporary
	M. E. Hansen, Temporary
	J. Prader
	J. A. K. Munthali, Temporary
E. A. Evans	M. J. Shaffrey, Temporary
	R. J. Lombardo
	A. Napky, Temporary
	S. Appetiti, Temporary
	A. M. Othman
	I. H. Thorláksson
	O. Kabbaj
	B. Goos
J. E. Ismael	T. Sirivedhin
A. Kafka	L. M. Piantini
	J.-F. Cirelli
	J.-L. Menda, Temporary
	B. A. Sarr, Temporary
	M. Al-Jasser
G. A. Posthumus	G. P. J. Hogeweg
	S. Yoshikuni
	N. Adachi, Temporary
	K. Ichikawa, Temporary

L. Van Houtven, Secretary and Counsellor
J. W. Lang, Jr., Acting Secretary
S. W. Tenney, Assistant
B. R. Burton, Assistant
M. Primorac, Assistant

Also Present

IBRD: M. E. Martinez, Latin America and the Caribbean Regional Office. African Department: R. O. Carstens. Asian Department: H. C. Kim, J. E. Zeas. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; T. Leddy, Deputy Director; E. Brau, G. R. Kincaid, B. C. Stuart, H. J. H. Trines. External Relations Department: E. Ray. IMF Institute: O. B. Makalou. Legal Department: F. P. Gianviti, General Counsel; W. E. Holder, Deputy General Counsel; R. H. Munzberg, Deputy General Counsel; E. Aguirre-Carrillo, P. L. Francotte, J. W. Head, R. Leckow, J. K. Oh. Research Department: M. R. Stone. Secretary's Department: C. Brachet, Deputy Secretary; A. Tahari. Treasurer's Department: G. Laske, Treasurer; J. E. Blalock, W. L. Coats, Jr., P. Fontana, P. S. Ross, G. Wittich. Western Hemisphere Department: S. T. Beza, Counsellor and Director; J. Ferrán, Deputy Director; J.-P. Amselle, L. A. Cardemil, C. H. Fisher, A. Hoffmeister, R. Incer, J. R. Karlik, S. Kawar, W. E. Lewis, C. M. Loser, L. L. Pérez, S. J. Stephens, E. C. Suss. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: J. O. Aderibigbe, J. Basiuk, M. B. Chatah, M. Eran, A. Gronn, M. J. Mojarrad, P. O. Montórfano, J.-C. Obame, F. A. Quirós, S. P. Shrestha. Assistants to Executive Directors: T. S. Allouba, G. Bindley-Taylor, C. Björklund, B. A. Christiansen, H. E. Codrington, S. B. Creane, S. K. Fayyad, B. S. Fuleihan, M. A. Ghavam, M. A. Hammoudi, A. Hashim, M. E. F. Jones, P. Kapetanovic, C. Y. Legg, R. Marino, J. K. Orleans-Lindsay, H.-J. Scheid, J. C. Westerweel.

1. SUSPENSION OF VOTING AND RELATED RIGHTS - REPORT TO BOARD OF GOVERNORS AND PROPOSED RESOLUTION ON THIRD AMENDMENT OF ARTICLES OF AGREEMENT

The Executive Directors continued from EBM/90/81 (5/25/90) their consideration of a draft report to the Board of Governors and a proposed Resolution on the third amendment of the Articles, as revised to reflect the discussion at EBM/90/81 (5/25/90), to provide for the suspension of voting and related rights (SM/90/101, Rev. 2, 5/25/90).

The General Counsel noted that some minor editorial changes were needed in the text of SM/90/101, Rev. 2. The word "date" in the final sentence of paragraph 3 of the proposed decision should be replaced with the word "time," thus that sentence would read: "Votes received after that time will not be counted." The word "those" in the second sentence in paragraph 7(a) of the draft report should be replaced with "the member," and the word "of" in the first sentence of paragraph 7(b) should be replaced with the words "allotted to."

Three substantive changes had been made in the draft report and proposed Resolution to reflect the agreements reached among Directors during EBM/90/81, the General Counsel continued. The texts of paragraph 3(c) and 3(c)(i) of draft Schedule L had been revised to reflect the difference in procedures for cases involving the suspension of a member's voting and related rights within 90 days of a regular election of Executive Directors and cases involving such a suspension more than 90 days prior to a regular election. In the latter case, an election for a new Executive Director would be held within 30 days from the date of the suspension. However, if the suspension took place during the 90-day period preceding a regular election, the Executive Director would remain in office until the election was held.

In addition, paragraph 3 of the draft Resolution had been revised, in line with the agreement that was reached during the previous meeting, that if a member's voting and related rights were reinstated before a subsequent regular election of Executive Directors had taken place, the member would automatically rejoin its former constituency, and if a member's rights were reinstated after a regular election had taken place the member would be permitted to join a constituency by agreement, the General Counsel went on.

Paragraph 4 of the draft Resolution had also been revised in accordance with Schedule D of the existing Articles, which prescribed that the constituencies of Councillors should be the same as the constituencies in the Executive Board, the General Counsel concluded.

Mr. Al-Jasser commented that the structure of the draft Resolution was confusing. He wondered whether paragraph 4 on page 15 of SM/90/101, Rev. 2 should have been numbered paragraph 3(d).

The General Counsel responded that paragraph 4 on page 15 had been numbered correctly; it was intended as the fourth paragraph of the proposed Schedule L.

Mr. Goos suggested that the structure of the proposed Resolution could be made more clear if the proposed amendments of the Articles were presented first and followed by the proposed Schedule L.

The General Counsel said that, while it was possible to change the order in which the amendments were presented, the reason for that order was that the first two paragraphs of the proposed Resolution pertained to the effects of the suspension of voting and related rights, and the last two paragraphs dealt with the effects of a termination of suspension.

The Chairman remarked that the current presentation of the amendment of the Articles would facilitate Governors' consideration of the substantive issues involved. Therefore, it would be best to maintain the proposed Resolution as drafted by the staff.

Mr. Goos stated that he wondered whether the draft report addressed the issue of whether members whose voting and related rights had been suspended could participate in meetings of the Interim Committee.

The General Counsel noted that the Interim Committee was not an organ of the Fund; it had been established by the Board of Governors as an advisory body. The proposed amendment would have an impact on the membership of the Interim Committee in that the suspended member would no longer have a Governor of the Fund. In that connection, it should be noted that the existing provisions of the Articles did not confer upon any member the right to send a representative to meetings of committees of the Fund, including the Interim Committee; rather, it was left to the body establishing the committee or to the committee itself to determine representation at the committee's meetings.

While the Board of Governors' Resolution that had established the Interim Committee did contain a provision under which officials of member countries that were not Governors of the Fund could participate in meetings of the Interim Committee, an amendment to that Resolution would need to be taken up for consideration separately from the proposed amendment of the Articles, the General Counsel said.

The staff was preparing a paper on changes to various By-laws, Resolutions, and Fund policies that might need to be considered as a result of the proposed amendment of the Articles, which would be brought to the Board in the near future, the General Counsel concluded.

Mr. Adachi said that his chair remained concerned about the wording of the title of the draft report and proposed Resolution. In particular, he wondered whether the word "of" should be replaced by the word "to."

The Chairman noted that the staff and the Japanese chair would consider an appropriate wording for the title of the draft report and proposed Resolution on a bilateral basis.

The text of the draft report and proposed Resolution had been agreed in a spirit of compromise among all Directors, and they were unanimous in hoping that the proposed amendment would never have to be invoked in the effort to solve the problem of overdue financial obligations to the Fund, the Chairman continued. In that connection, if the mere existence of the proposed amendment helped to avoid a situation in which a member's failure to fulfill its obligations become so egregious as to warrant its use, it would have been successful in serving its primarily deterrent function.

The same positive energy that had been demonstrated by Directors over the course of previous meetings on the proposed amendment should be used to ensure that the amendment would be ratified expeditiously and in a way that would reinforce the cooperative spirit of the Fund--which would, in turn, increase the likelihood that the Fund would never have to resort to the provisions on the suspension of voting and related rights, the Chairman considered.

Nevertheless, it was important to note that the ratification of the proposed amendment of the Articles was only part of the strengthened cooperative strategy on overdue financial obligations, the Chairman went on. The implementation of the rights approach and the approval of the contingent gold pledge were also crucial elements of the strategy, which needed to be put in place as rapidly as possible, and well before the end of 1991, if it was to succeed.

In the light of those considerations, every member of the Fund should be urged to ratify the proposed amendment, to approve the pledge of gold, to make every effort to facilitate the rights approach, to participate in support group efforts, and to join forces in encouraging the pursuit of appropriate economic policies, the Chairman stated. The lengthy negotiations that had gone into concluding the discussion on the problem of overdue financial obligations highlighted the need for a positive spirit on all parts in the effort to solve the problem of arrears and bring all members back into the mainstream of the international financial community.

Following some further brief discussion, Directors approved the proposed decision, as amended.

The decision was:

1. Pursuant to the request of the Interim Committee that an amendment of the Articles of Agreement be proposed providing for suspension of voting and related rights of members that do not fulfill their obligations under the Articles, the Executive Board:

a. adopts the "Report of the Executive Board to the Board of Governors on the Proposed Third Amendment of the Articles of Agreement of the International Monetary Fund" (SM/90/101, Rev. 2);

b. proposes the introduction in the Articles of Agreement of the modifications included in the Proposed Third Amendment attached to the Resolution in Part IV of the Report; and

c. recommends the adoption by the Board of Governors of the Resolution in Part IV of the Report.

2. The Executive Board notes that the Secretary has been authorized and directed by the Chairman of the Board of Governors of the Fund to bring before the Board of Governors on his behalf by rapid means of communication the proposal of the Executive Board introducing modifications in the Articles of Agreement pursuant to the request of the Interim Committee. The Executive Board authorizes and directs the Secretary to send to each member of the Fund this proposal of the Executive Board together with the Report, with a request for a vote by each Governor on the Resolution in Part IV of the Report.

3. The Board of Governors is requested, pursuant to Section 13 of the By-Laws, to vote without meeting on the Resolution in Part IV of the Report. To be valid, votes must be received at the seat of the Fund before 6:00 p.m., Washington time, on June 28, 1990. Votes received after that time will not be counted.

4. The effective date of the Resolution of the Board of Governors shall be the last day allowed for voting.

5. The Secretary is authorized to take such action as he shall deem necessary or appropriate to carry out the purposes of this decision.

Decision No. 9443-(90/83), adopted
May 30, 1990

2. BARBADOS - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with Barbados (SM/90/65, 4/17/90). They also had before them a background paper on recent economic developments in Barbados (SM/90/70, 4/26/90).

The staff representative from the Western Hemisphere Department made the following statement:

> Subsequent to the circulation of the staff report for the 1990 Article IV consultation with Barbados, the Prime Minister, who is also Minister of Finance, presented to Parliament the Central Government's Budget for the fiscal year which began April 1, 1990.
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> Total revenue and grants have been estimated at BDS$1,002 million, equivalent to 28 percent of GDP, or marginally higher than in the previous fiscal year; the revenue estimates allow for certain minor adjustments in the tax system that are aimed at reducing the tax burden for certain activities, particularly the export sector. Total expenditures have been projected at BDS$1,129 million, or roughly 31.7 percent of GDP, representing a 12 1/4 percent increase from their level in 1989/90. The wage bill would rise by the equivalent of 1.1 percent of GDP, current transfers by 0.8 percent of GDP, and capital outlays by 0.8 percent of GDP (assuming a 90 percent rate of implementation). Of the roughly 16 1/2 percent increase in the wage bill in 1990/91, approximately 9 1/2 percentage points represent costs associated with the regrading of civil service positions, including retroactive payments for 1988/89 and 1989/90. In all, the overall central government deficit would widen to about 3.6 percent of GDP in 1990/91 from a deficit preliminarily estimated at 1 percent of GDP in 1989/90.
>
> Gross disbursements of foreign project-related loans would amount to BDS$77 million, implying that, after allowing for amortization payments of some BDS$93 million, the Government would need to mobilize additional resources from domestic and foreign sources equivalent to nearly 4 percent of GDP to cover its financing requirement.
>
> In his budget presentation, the Prime Minister indicated that the existing tight monetary stance would be relaxed effective June 1, 1990. The staff had hoped to be in a position to indicate to Executive Directors the nature of any new monetary measures, but it is our understanding that the details of modification to credit policy and interest rates are still being worked out.
>
> The staff continues to be of the view that a strengthening of the fiscal position in 1990/91 would be essential to alleviate pressure on resources and to strengthen the balance of payments; indeed, achievement of the authorities' international reserve objective would seem to require a shift toward surplus in the central government finances, if private investment is not to be crowded out. It would therefore be important that the authorities seek ways to contain the central administration deficit through administrative or other means. In particular, it should be noted

that the projected rise in the wage bill seems to allow for a sizable general wage increase--in addition to the cost of regrading--and the authorities would be well advised to reconsider such a move from the viewpoint of both the fiscal policy requirements and the country's competitive position. Moreover, unless the fiscal position can be strengthened considerably, monetary and credit policy will need to be tightened, with increased interest rate flexibility, to protect the balance of payments.

Mr. Noonan made the following statement:

Since the mid-1980s the economy of Barbados has experienced a period of continuous and significant growth. Real GDP in 1989 was estimated to be almost 17 percent greater than it was in 1984. This good performance was achieved despite a sharp fall in the production of sugar, the principal agricultural product, and no net increase in manufacturing output. Overall growth was sustained by the expansion of tourism and construction, and my Barbadian authorities expect that tourism will continue to grow and generate a substantial inflow of foreign exchange in 1990 and beyond.

The gains in real GDP were accompanied by a significant increase in job numbers. Nevertheless, unemployment remains high because of a rapid increase in the labor force, mainly owing, as the staff appraisal notes, to a large increase in the participation rate. In the view of the authorities, the possibilities for greater job creation rest on further diversification of the economy. In this regard, the World Bank is assisting in a study of the manufacturing sector which will inform policy on a number of issues, in particular, incentives, protection, marketing and restructuring. A vigorous manufacturing sector is needed not only to provide jobs but also to supplement foreign exchange earnings, and so help to stabilize international reserves, which came under some pressure in 1989.

Pending the completion of the World Bank study, the 1990 budget contained a number of initiatives which were designed to strengthen the country's productive base and its foreign exchange earning capacity. The Income Tax Act is to be amended to provide an export allowance to data processing companies and companies that purchase wholesale from local producers exclusively for export. In addition, there will be a reduction in the effective rates of taxation on the exports of enclave enterprises. Business houses involved in the sale of duty-free goods to tourists will be allowed to remove such items from their warehouses for display and sale to visitors without the prepayment of duties and taxes. Spare parts for use in agriculture, fisheries, and manufacturing can now be imported free of import duty and consumption tax.

The 1990 budget also allows for some improvement in the cash flow position of businesses and provides some incentives for new investments. For example, the grace period allowed for the payment of consumption taxes has been lengthened. All company losses can be carried forward for tax purposes with effect from this tax year, and intercompany loans will no longer be taxed as income of the company receiving the loan. In recognition of the significant growth potential of small businesses, the budget provides an increase in the amount of concessional funds available from development agencies. There are also incentives for the purchase of shares in private companies.

Notwithstanding the noticeable reduction in the fiscal deficit during 1989, my authorities are in broad agreement with the staff as regards the need for greater fiscal consolidation. However, they believe that the incentives offered in the budget will not have a negative impact on the fiscal position. Given a positive output in response to the budget, these measures are likely to be self-financing and generate additional foreign exchange. If they fail to evoke the expected response, it would mean that the concessions would not be used, and there would be little or no revenue loss.

With regard to public expenditure, while my authorities agree with the thrust of the staff's views, they must point out that there were serious, practical difficulties in the way of any attempt to freeze the public sector wage bill in 1990. The regrading exercise, which has now been completed, was originally due for implementation in 1988. It already had been postponed on several occasions but the authorities were unable to prolong those delays any further. While they would have preferred to avoid incurring this large increase in expenditure at the present stage, my authorities are hopeful that, in bringing the salaries of some civil servants closer to those paid for comparable work in the private sector, there will be a corresponding improvement in morale and productivity. They also would have preferred a more selective regrading, but did not win adequate support for that position. With the completion of the regrading exercise, and having regard to the projected moderate level of inflation in 1990 and 1991, the authorities are confident that they can hold the line on wages in the immediate future.

As to the effects of the regrading on the overall competitiveness of the economy, my Barbadian authorities see cause for concern only if private sector workers insist on perpetuating their earlier wage differential vis-à-vis government workers. The expected stability of prices during the medium term should help to avoid that eventuality. More generally, however, my authorities are convinced that the future of the export sectors does not lie with low-cost production, given the existing wage structure and comparatively high living standards. In this regard, they have had some success in efforts to attract investment in less cost-sensitive activities like data processing, captive insurance, and international business companies which can support a higher level of wages.

My authorities are aware that the pressure from wages and other items of expenditure could raise the fiscal deficit to about 6.1 percent of GDP in 1990. Though this would represent a substantial increase in the relative size of the fiscal deficit compared to the estimated outturn for 1989/90, they would wish to view such a prospective deficit as a worst case scenario. It is their expectation that a combination of improved efficiency in revenue collection, higher revenue yield from increased economic activity and a tightening of expenditure control mechanisms will produce a more favorable outcome. To this end, the intention is to introduce, as a matter of priority, a number of administrative improvements. These changes will include additional training and more effective surveillance and processing, in the Customs, Inland Revenue, and Land Tax Departments. The Ministry of Finance will also monitor closely the operations of all government ministries, departments, and corporations, with a view to ensuring that budget allocations are not exceeded. In addition, beginning with the 1991 financial year, greater emphasis will be placed on cost/benefit assessments of expenditure programs.

My Barbadian authorities would also like to draw attention to their longer-term perspective of the economy, which they feel should give reason for optimism. Since 1982, retail price increases have not risen above 6 percent and are not expected to do so in the foreseeable future. Moreover, on the strength of a faultless debt-service record, Barbados' international credit rating remains high. The recent reduction in the debt and debt-service burdens has provided some leeway for additional borrowing to relieve the foreign exchange constraint. My authorities expect that any borrowing in 1990 will be relatively small. The economy is therefore well positioned to continue on its long-run growth path and the policies of the authorities, subject to the political and other constraints to which they must have regard, are intended to facilitate this process.

Continuing, Mr. Noonan said that the difference in the size of the fiscal deficit mentioned by the staff representative and that given in his own statement was largely due to adjustments made by the staff to the figures given in the budget statement. He also said that the revision of monetary policy was still under consideration.

Mr. Enoch made the following statement:

The concise staff paper before us sets out clearly the major economic issues facing the Barbadian authorities. Mr. Noonan's helpful statement focuses on some of these issues, and provides an interesting update. Since I broadly share the staff's analysis, I will cover just a few points.

Looking first at fiscal policy, at the last Executive Board discussion on Barbados (EBM/88/21, 2/17/88), Directors expressed concern about the widening public sector deficit. Since then the authorities have made impressive progress in improving their fiscal position. In each of the last two years, expenditure has fallen and revenue increased as a percentage of GDP. Nevertheless, I have to agree with the staff that continued fiscal restraint will be necessary, in order to reduce the Government's indebtedness to the banking system and to bring about an increase in external reserves. I would also agree with the staff's conclusion that the bulk of the burden of further fiscal adjustment will need to fall on expenditure, at least in the short term. The study of the tax system which the authorities are currently undertaking is welcome, and should indeed, as the paper suggests, serve as the basis for decisions needed in the taxation area. However, the recommendations of the study will clearly take some time to implement.

While Mr. Noonan has defended the authorities' recent decision to give tax incentives to businesses, the authorities need to be very careful in this area. It is too easy to give windfall gains to businesses which would in any case have located and produced in the country; thus, any incentives must be crafted carefully. There is, of course, a risk that a weak response to incentives may lead the authorities to seek to increase the incentives. With other countries competing similarly for these businesses, such a process would clearly be self-defeating.

Meanwhile, the authorities' commitment in 1989 to a restrained monetary policy to support their fiscal efforts has been appropriate. The authorities' intention to give consideration to structural reforms in the area of monetary policy, and in particular the elimination of the ceiling on mortgage rates and on the maximum average rate applicable to specified commercial bank loans, is welcome. The background paper describes the wide range of ad hoc monetary policy measures introduced by the authorities over the last couple of years. There seems therefore to be a pressing need for structural reforms in this area, and I hope that the authorities can implement them quickly.

Turning to broader structural policies, I welcome the studies on tourism and manufacturing that are being undertaken with the assistance of the World Bank. However, I share the staff's concerns about some of the measures contemplated to support the sugar industry. The authorities' decision to guarantee the minimum price for sugar over a three-year period seems, on the face of it, to be inconsistent with their other policy objectives.

Tourism has been the main source of growth in Barbados over the past few years. The authorities' success in attracting summer tourists from Europe shows how diversification can be pursued successfully even within an industry. However, the fact that no new hotels have been built in Barbados in recent years suggests that there may be underlying factors which could lead to possible problems over the medium term. Clearly, analysis of how the Barbadian authorities should develop their tourist policy requires a regional perspective, and the tables in the background paper are helpful in this regard. I infer from the staff's discussion of tourism that Barbados seems to be one of the few countries in the region not to be seeking to move its tourist industry up-market. If so, the authorities' approach may well be appropriate. There clearly is a considerable market at the competitive end of the tourist range.

A principal problem facing the authorities is that of unemployment. The current rate of about 18 percent is obviously of great concern. I note, however, from the background paper that there are nevertheless labor shortages, both in the sugar and cotton industries, and among skilled artisans and managerial personnel. In addition, the background paper observes that the dominance of a single union in the private sector weakens the link between productivity and wages. I would, therefore, be interested in staff comment as to whether the authorities are contemplating labor market reforms.

I note also from the background paper that the problems of the sugar sector derive in part from the high level of its indebtedness. The proposed staff work on the implications of domestic indebtedness for a country's external economic performance is clearly of relevance here. Insofar as the authorities may at some stage seek to assume part of the burden of past indebtedness, they will reinforce the case for overall fiscal consolidation.

The medium-term scenarios presented by the staff are interesting, and reinforce the case for fiscal prudence. Given the authorities' maintenance of a target level of reserves, a more relaxed fiscal stance will lead to higher government external borrowing. Although the authorities have in the past been able to borrow externally without difficulty, the authorities should not take any risks with their creditworthiness. Even in the favorable medium-term scenario, there is likely to be a significant increase in the debt-service ratio over the next couple of years. The authorities should be very wary of pushing that ratio even higher.

Finally, Barbados seems overall to have been well served by its exchange rate policy, which clearly requires considerable restraint in domestic costs, particularly wages. In this context, the staff has argued for no further wage increases for civil servants in 1990/91 to set the tone for moderation in private sector wage management. But given the wage increases that have been given, which Mr. Noonan explains in terms of political factors, the authorities certainly need to press ahead to seek significantly improved productivity in the public sector. I endorse the staff comments in this regard. Overall, the authorities need to contain the high cost structure of the Barbadian economy to safeguard the exchange rate, contain inflation, encourage investment, and facilitate the prosperous future which Barbados has the potential to achieve.

Mr. Shaffrey said that while Barbados had recorded a reasonably good performance in terms of economic growth over the past few years, it clearly faced a number of problems. However, if those problems were faced up to resolutely, Barbados would be able to attain a path of sustainable growth. The staff appraisal provided a good starting point for the authorities as they considered how best to address the economy's problems, and he endorsed the staff's analysis.

Over the past few years, Barbados had been beset by falling agricultural production, and a slump in manufacturing output; the latter was only now showing signs of recovery, Mr. Shaffrey observed. Fortunately, a boom in tourism had offset those adverse factors, although tourism growth now showed signs of tapering off. The task confronting the authorities was to ensure that those important components of the economy either remained--or were made--competitive. As emphasized by the staff, wage restraint would be critical in enhancing competitiveness, and so he hoped that the authorities could minimize the impact on private sector wages of the current regrading exercise for civil servants.

Public finances now appeared to be in better shape but he admitted to some alarm over the admission by Mr. Noonan that the fiscal deficit had the potential to reach 6 percent of GDP that financial year, Mr. Shaffrey continued. The staff representative's statement indicated that the outcome might not be as bad as that. He endorsed the staff's view that further fiscal consolidation was necessary, both to avoid the necessity of further increasing the tax burden and to help relieve the pressure on the balance of payments. Expenditure restraint was of paramount importance, especially in respect of public service salaries and wages, given the substantial real increase in remuneration over the past five years. Nonfinancial public enterprises had made some commendable efforts to reduce their drain on the public purse; some benefits were apparent, but one or two enterprises were still in need of reform. He urged the authorities to take the necessary actions to improve their performance.

Although he welcomed the tightening of monetary policy in late 1989, he was not at all sure that the relaxation announced that day was appropriate, as it might well give the wrong signal on wage restraint, Mr. Shaffrey remarked. He thought that monetary policy would be far more effective if not hampered by interest rate and credit controls. Credit controls had clearly been a failure, while interest rates had not been able to adjust to reflect the demand for credit; they had distorted the financial markets and adversely affected the balance of payments.

Turning to the agricultural sector, he hoped that the forthcoming strategy for addressing its structural problems would provide the impetus for diversification, Mr. Shaffrey commented. As for the sugar industry, the authorities were wise to have limited production, given the lack of competitiveness, although the wisdom of the additional subsidy was less obvious. The industry had a long list of ills, none of which would be easy to fix, but the existence of efficient operations showed that the sugar industry could be rehabilitated.

Mr. Ichikawa made the following statement:

> We welcome the improvement in the public finances of Barbados in 1989, as attested by the further reduction in the overall fiscal deficit, which is the result of the successful implementation of the new tax measures and of expenditure retrenchment. Despite this fiscal improvement, however, the authorities are facing difficulties in coping with the persistently high unemployment rate and strong inflationary pressures. Furthermore, the weakening in the external balances is a source of serious concern. The strong growth in imports caused a widening of the current account deficit which, along with the decrease in official market borrowing, led to a sharp decline in gross official reserves to an uncomfortable level.
>
> Against this background, we strongly encourage the authorities to undertake a comprehensive adjustment of the economy in order to strengthen its competitiveness and to ensure viable growth over the medium term. To this end, the authorities need to reinforce the fiscal adjustment efforts by implementing a tight monetary and incomes policy. In this regard, the recent relaxation of fiscal and monetary policy is disappointing. We also agree with the staff that, to achieve the macroeconomic targets, the authorities need to take extremely strong adjustment measures in the absence of adjustment of the nominal exchange rate.

Turning to specific policies, we agree with the staff that the emphasis in fiscal policy should be on curtailing current expenditure, particularly the wage bill. In view of the substantial progress in revenue enhancement during the past year, the burden of fiscal adjustment should be borne primarily by current expenditure. We note that, despite the high unemployment rate, the average wage increase has been substantial in recent years, outpacing retail price increases. As noted in the background paper, civil service wage contracts have a significant influence on private sector wage settlements. A restrictive stance on the wage bill may bring about a much needed slowdown of the wage-inflation spiral. We also agree with the staff that in order to achieve the fiscal target, the public enterprises need to be streamlined.

On monetary policy, given the substantial reduction in the money supply, the private sector's strong demand for credit in 1989 is not sustainable. While we can endorse the monetary restraints adopted in late 1989, particularly the restrictive credit policy, we are somewhat concerned about how effective they will be in cooling down the economy. The staff may wish to elaborate on the recent changes in interest rates and inflation. We also urge the authorities to consider eliminating the maximum average lending rate. While we note that no ceiling has been applied to consumer credit, the narrowing of the interest rate spreads under heavy credit demand pressure has weakened the banks' financial structure. The commercial banks' poor record of compliance with official lending limits is another reason for introducing market-determined interest rates, in order to enhance the competitiveness of the economy.

On the external front, the sharp widening of the current account deficit and the decline in official reserves in 1989 raise doubts about the sustainability of the current growth. As the staff's two scenarios project, the achievement of sustainable growth over the medium term hinges upon the authorities' ability to tighten financial policy comprehensively. In view of the worrying decline in gross reserves and the uncertainties in the external debt situation, the strengthening of external competitiveness is a matter of urgency. If the authorities fail to undertake sufficient adjustment in domestic policies, or if the tightening of financial policy falls short of restoring external competitiveness, the authorities may need to take complementary action in the area of nominal exchange rates.

Ms. Hansen made the following statement:

As we are in broad agreement with the staff report, I will only make a few brief points. First, it is quite apparent that

Barbados is extremely vulnerable to external shocks, especially those which could have an adverse impact on tourism, which provides such an overwhelming share of foreign exchange earnings. Therefore, it is very important to keep external borrowing low, to maintain a comfortable reserve position and to be prepared to take immediate corrective actions if an external shock occurs.

We agree, therefore, on the need for restrained fiscal and credit policies. In this connection, the forthcoming relaxation of the monetary stance and the budget estimates for the current fiscal year seem to be moving in the wrong direction. On the fiscal side, there would appear to be considerable room to improve the financial performance of the nonfinancial public sector enterprises, which have been operating at a significant loss for a number of years. For 1989/90, for example, it is estimated that losses from these enterprises will be equivalent to nearly twice the overall public sector deficit, or about 2 1/2 percentage points of GDP. Some combination of improved efficiency and more appropriate pricing would seem to be warranted. Certainly, mobilizing resources in this manner would be superior to raising taxes to cover these losses. The authorities might also consider partial, or complete, privatization of some of these enterprises, using the proceeds to reduce the country's external debt. We also share the staff's concern about the sugar subsidy, especially in the absence of a clear strategy for increasing the efficiency of the sugar industry.

Another major concern is the steady increase in public sector wages, which not only contributes to the fiscal deficit, but also undermines the competitiveness of the economy, to the extent that public sector wages spill over into export services and manufacturing. As a small, open economy, Barbados cannot afford to disregard cost competitiveness, even if, as Mr. Noonan points out in his statement, Barbados is not seeking to specialize in low-cost production.

With regard to exchange rate policy, the authorities' objective of maintaining a fixed parity with the dollar as an anchor for their policies is commendable in principle, but needs to be supported with appropriate domestic policies. We agree with the staff, particularly on the need for a restrained wage policy in the public sector to set the standard for private sector wage settlements, if the needed gain in competitiveness is to be obtained without an exchange rate adjustment. It is worth noting, however, that this policy course implies a rise in unemployment in a situation where unemployment is already high. Under these circumstances, tight financial policies and a restrictive wage policy, combined with some exchange rate adjustment, could be expected to yield faster gains in competitiveness, more rapid export diversification and stronger employment growth.

We are pleased to know that World Bank studies on tourism, manufacturing, and the agricultural sector are nearing completion and hope they will provide a basis for improving competitiveness in these sectors, accelerating the diversification of the economy and creating more jobs.

In conclusion, Barbados has performed relatively well in some important respects, but with stronger policies, we believe it could make greater headway in reducing its vulnerability to external shocks and in increasing employment.

Mr. Goos said that he fully agreed with the staff appraisal. The information received from the staff at the beginning of the meeting prompted him to express his concern about the worsening fiscal position of Barbados. He therefore urged the authorities to reconsider their policy stance and to bring it more in line with the staff's recommendations.

On present policies and policy intentions, there was a clear risk that inflationary pressures would arise, as well as pressures on the external accounts, Mr. Goos noted. The authorities' exchange rate policy, in particular its intended use as a monetary anchor, could no longer be sustained without severe adverse effects on overall stability and growth.

Mr. Posthumus said that, in view of the information provided by the staff, he wished to ask Mr. Noonan a question about the several measures that had been taken to stimulate exports--an amendment to the Income Tax Act to provide for an export allowance and reductions in various taxes on exports and which he had described as not having negative effects on the budget because they were self-financing. Many countries had tried that approach before: most of them had failed to see results, and the Board should be very clear in its advice to the authorities that such tax incentives would not achieve the results the authorities intended.

The staff representative from the Western Hemisphere Department said that the staff had mentioned the importance of restraint in wages to the Prime Minister; he had responded that during the coming fiscal year he would explain to all parties involved the need for restraint, including an improved system of wage determination, if exchange rate stability were to be preserved. The staff did not know if there had been any subsequent attempts at reform.

Although the staff had hoped to have further information on the interest rate structure, the authorities were still working out the details, the staff representative remarked. In response to a further question from Mr. Ichikawa, the staff representative said that the inflation rate remained at about 6 percent.

Mr. Noonan said that his Barbadian authorities had no more evidence than anyone else of the effectiveness of self-financing tax incentives. The consistency of the warnings sounded by Directors regarding fiscal, and particularly wages, inflation, and monetary policy, and the emphasis they had placed on the need for restraint had been noted. He would faithfully convey those sentiments to his Barbadian authorities.

The Chairman made the following summing up:

Executive Directors were broadly in agreement with the thrust of the appraisal in the staff report for the 1990 Article IV consultation with Barbados.

In reviewing the economic situation and prospects for Barbados, Directors noted that during the past six years real GDP and employment had grown at an encouraging pace. Directors observed, however, that unemployment remained high, and that recently the rate of inflation had picked up.

Directors welcomed the reduction in the overall public sector deficit from 6 percent of GDP in 1987/88 to just over 1 percent of GDP in 1989/90, but they were concerned with the implications of the Government's budget for 1990/91, which contemplated a substantial widening of the deficit. Directors emphasized the need for a stronger fiscal stance as essential for alleviating pressure on financial resources, for containing government debt to banks, and for strengthening the balance of payments, especially following the decline in net international reserves that had occurred in 1989. Directors felt that the major focus of fiscal adjustment should be directed to expenditure restraint. They were particularly concerned about the sharp increases in the wage bill and in transfers that had been budgeted for 1990/91, as well as the potential impact of these developments on wages and costs in the private sector.

Directors also expressed concern about the contemplated easing of monetary policy. They believed that, together with an adequate strengthening of the fiscal position, monetary policy would need to be kept tight. It would be essential in particular to work toward increased interest rate flexibility in order to curb inflation and protect the balance of payments as well as to improve the allocative efficiency of financial intermediation.

Directors noted the authorities' intention to undertake, with assistance from the World Bank, reforms to correct structural weaknesses in the productive sectors of the economy. Forthcoming studies on the competitive position of the tourism sector and on incentives affecting manufacturing were expected to provide the basis for important structural initiatives. Directors regretted the reintroduction of a subsidized support price for sugar, and they urged the authorities to formulate a comprehensive strategy to address structural problems affecting agriculture.

In discussing the Government's development strategy, Directors asserted that, with the maintenance of the existing parity of the Barbados dollar, financial and wage policies would need to be tight enough to bring down domestic production costs in relation to costs in Barbados' major trading partners. It followed that, even with a significant tightening of policies from those contemplated in this year's government budget, the process of reducing unemployment was likely to be a slow one because it would take time to achieve the needed gains in competitiveness.

Directors noted that the Government's cautious debt management policy had helped to reduce Barbados' debt service burden, but that Barbados would need to continue to have access to commercial financing abroad as its foreign debt obligations matured. Reference was made to the possibility of utilizing privatization proceeds for reducing the stock of debt. In this regard, the importance of sound financial policies in preserving Barbados' creditworthiness was emphasized.

It is expected that the next Article IV consultation with Barbados, under the bicyclic consultation procedure, will be completed within 24 months.

3. ST. LUCIA - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with St. Lucia (SM/90/77, 4/30/90). They also had before them a background paper on recent economic developments in St. Lucia (SM/90/79, 5/3/90).

Mr. Noonan made the following statement:

Subject to reasonable weather conditions this year, real GDP in St. Lucia is expected to be some 25 percent greater than it was only five years ago in 1985. Nevertheless, the country is still relatively underdeveloped, with an average income of less than US$2,000 per head. Inflation peaked in 1987 when consumer prices rose by 7 percent but it has since returned to a more sustainable level. Consumer price inflation in 1989 was 4.4 percent and is projected at about 4 percent in 1990. Although the current external deficit grew significantly in 1989 and is expected to remain above 10 percent of GDP until at least 1993, substantial capital inflows, largely on concessional terms, will ensure that the overall external account remains in surplus until 1992 at least. My authorities agree with the assessment of the staff mission that the level of the exchange rate is appropriate and consistent with the prevailing economic fundamentals.

Since the last Article IV consultation, my St. Lucian authorities have eliminated all external arrears, reduced their domestic debt, and increased their net foreign holdings. The major challenge now facing them is to maintain macroeconomic conditions conducive to continued sustainable growth while, at the same time, building up an infrastructure that will support a bigger and more diversified economy. In this latter context, my authorities wish to acknowledge the substantial external assistance, and particularly the loan finance on concessional terms, which they are receiving. My authorities also intend to ensure that the economic development of St. Lucia will be consistent with the conservation of the island's natural environment. Efforts at agricultural diversification are being pursued in this context, both at the national level and in conjunction with regional neighbors, bearing in mind the need to prepare for the challenge of 1992 and beyond.

The staff report perceives that the rapid growth in public capital expenditures, supported by external financing, may be associated with an inflationary threat to the economy. My St. Lucian authorities, while recognizing this potential problem, realize that the future flow of external resources, and particularly concessional finance, is not within their discretion. They are keenly aware of the current international competition for scarce capital resources, especially concessional financing, and believe that if they do not make full and effective use of the resources currently available to them, there is no guarantee that those resources will continue to be available in the future. Consequently, my authorities intend to press ahead with their major capital development projects to expand electricity generating capacity, improve the electricity distribution network, expand water resources, and improve roads, telecommunications, ports and airports. Joint venture possibilities for the development of St. Lucia's geothermal resource are being explored and are expected to reduce dependence on imported fossil fuels eventually.

In order to alleviate demand pressures arising from the increase in the scale of the capital program, the buildup of liquidity in previous years, and the rapid expansion of the construction and tourism sectors, consideration is being given to exercising greater flexibility in granting work permits. Over the longer term, emphasis will be put on increasing St. Lucia's labor resources in terms of an educated and skilled workforce. In addition, firm control of public expenditure will be maintained--with particular attention being given to the phasing and costs of public contracts. Moreover, following the 1989 decline in the liquidity of the commercial banks, consumer bank credit will likely be tightened in 1990.

Another issue being addressed by my St. Lucian authorities concerns the tourist industry. The expansion of this industry continues to have a major impact on economic growth. The construction boom, for instance, has been driven to a substantial extent directly by the growth of tourism, and also indirectly through the demand arising from that industry for infrastructural and other improvements. The tourist industry is almost entirely within the private sector and much of the recent expansion in capacity has been financed by foreign private capital. There is concern that private capital from external sources is increasingly being associated with the phenomenon known as "enclave tourism." That phenomenon is manifested in the relative isolation of some major tourist businesses from the local economy, with substantial dependence on imports of both goods and services, and with the repatriation of profits. Consequently, the net benefits of "enclave tourism" for the local economy tend to be small in proportion to the overall size of the business. My authorities are taking steps to ensure closer integration of all segments of the tourist industry with the local economy. Scope is seen for greater provision of both quality domestic produce and skilled labor to the industry and my authorities are directing their policies to facilitate the realization of those opportunities.

My St. Lucian authorities propose to continue prudent fiscal and monetary policies to support the current phase of rapid development with price stability. In that context, my authorities propose to allocate some of their increased resources to build up a stock of disposable reserves in order to provide against future contingencies. In furtherance of the objective of rationalizing foreign exchange controls, my St. Lucian authorities are examining the exchange control regulations in conjunction with the other members of the Eastern Caribbean Central Bank, with a view to their liberalization and achieving regional consistency. In addition, the foreign exchange tax has been systematically reduced from 2 percent in 1989 to 1 percent in 1990. My authorities intend to eliminate the tax in 1992 when loan repayments, to which it is linked, have been fully met. Subject to reasonably favorable environmental and external conditions, they expect that their prudence will continue to generate sustainable growth, leading to significantly improved living standards for all their people.

Mr. Enoch made the following statement:

I welcome the strong revival of growth in St. Lucia since the 1987 hurricane, and the maintenance of a relatively low level of inflation. The authorities seem to have managed the economy commendably over the past few years, and are well aware of the major policy issues before them. The fiscal position has strengthened significantly, in large part because of better tax administration and a useful tax reform. The authorities are prudently intending to sterilize part of the domestic fiscal surplus by building up the country's foreign reserves: given the uncertainties facing the country, it may well be appropriate for the authorities to maintain this policy for some time. I welcome the elimination of domestic arrears.

I will touch on just a few issues. First, the authorities' containment of current elements of their fiscal expenditure stands in marked contrast to experience in a number of other countries. Their policy is already paying off, both in terms of making room for the public sector investment that is necessary for the economy and through contributing to the fiscal surplus by reducing the vulnerability of the economy to future adverse exogenous developments. The recently announced public sector wage agreement looks as though it will maintain this strengthened position, as well as keep inflation under control. I note, however, that there was a significant increase in expenditure on wages in 1989 because of a major retrospective wage award. I would be interested in a staff comment as to whether the retrospective award last year was an exception, or whether the effect of the restrained award for the coming two years may be undone by retrospective increases in the future.

Turning to financial developments, there may have been excessive credit expansion, particularly in 1988 when banks increased their lending to the household sector. The staff report notes that the staff expressed some concern at this development to the authorities. I would be interested to hear whether the staff considers the upsurge in inflation in 1989 significantly related to the expansion of credit, or whether it can be attributed more to exogenous developments such as the higher oil price.

St. Lucia is clearly constrained in its operation of monetary policy by its membership in the Eastern Caribbean Central Bank. Appendix III, "The Eastern Caribbean Central Bank," of the background paper (SM/90/79, 5/3/90) gives a detailed account of the powers available to the Central Bank. It is interesting to read on page 38 of that same appendix that the Central Bank can discriminate between individual members both in determining the amount of government securities that commercial banks in member countries must hold, and in setting maximum and minimum interest rates. I note that the powers of differentiation have essentially not been used to date, and that even the general powers have barely been used. This passive stance seems in marked contrast to that of St. Lucia's commercial banks, which put up the deposit rate by 2 percentage points in response to a perceived lack of domestic savings. The continued enormous differential between savings and deposit rates, and the lack of any movement in lending rates, suggests that the domestic banking system displays limited competition. I would be interested therefore to hear whether the rise in savings rates reflected moral suasion--which I see from the background paper is an instrument that has been used in other instances by the Eastern Caribbean Central Bank--and also what the impact of these higher interest rates was on savings in other countries in the region.

The background paper also provides a very useful analysis of the world banana industry in Appendix I, and of the possible impact of a single European market. This analysis shows clearly the need for St. Lucia to diversify. The staff's comment that the supply response in St. Lucia and the other Windwards is significantly less than that of other suppliers is worrying, and the authorities need to consider the situation carefully. I was slightly surprised at the staff comment that the recent high price for bananas has undermined efforts at diversification. Appendix II of the background paper summarizing changes in the tax system in 1988-90 suggests a fair degree of fine tuning by the authorities regarding taxes and levies on banana exports that indicates that the authorities are able to create a wedge between world and producer prices if they feel that world prices are providing inappropriate incentives. Indeed, the main part of the discussion on the agricultural sector on page 2 of the background paper reports that lower prices in 1989 were not passed on to producers, as the St. Lucia Banana Growers' Association decided to support the earlier increase in the producer price. I would be interested in staff comments.

I note that there are significant weaknesses in the data supplied by the authorities, particularly on the real side and on social indicators. This deficiency cannot help economic analysis and policymaking, and I strongly urge the authorities to complete their rebasing exercise soon.

In conclusion, I commend the authorities for their prudent fiscal policies, and their attempts to date at economic diversification. I urge them to maintain their current stance. I also welcome the regional analysis in two of the appendices of the background paper. However, a number of serious regional questions remain unanswered. For instance, the staff reports that the authorities are now prepared to permit some temporary immigration of skilled labor to meet emerging shortages. It would be interesting to know from where in the region such labor might come. I would therefore once again endorse the Deputy Managing Director's earlier suggestion that the small Caribbean economies should continue to be studied individually on a bicyclic basis, and that perhaps a regional analysis covering them all might be conducted in the intervening year.

Mr. Menda said that during the past few years, St. Lucia's economic performance had been excellent, with real GDP up 4 percent in 1989, after an increase of 7 percent in 1988. Inflation had accelerated moderately from 1 percent to 4.5 percent. The current account had deteriorated to 15.5 percent of GDP from a deficit of less than 1 percent of GDP in 1988, but the overall surplus on the balance of payments had been maintained at about 2 percent of GDP. Furthermore, the Government had been able to eliminate all external arrears. Indeed, St. Lucia's pursuit of strict macroeconomic policies and the implementation of a coherent strategy of diversification provided a good example of the preconditions for sustained economic growth.

Fiscal policy had played a major role in the economic performance of recent years, Mr. Menda noted. With revenues reaching about 45 percent of GDP, the authorities had succeeded in mobilizing domestic resources. That achievement was certainly remarkable since a low level of revenues in relation to GDP was often a major cause of economic difficulties. The authorities had also succeeded in strictly controlling current expenditures. Following the rigorous wage policy set up in 1985, the Government's wage bill had declined from 55 percent of revenues to 36 percent in 1988. The recent agreement would result in a significant current increase; however, it provided for only moderate increases in the three years ahead. All in all, the combination of revenue-enhancing measures and strict expenditure controls had resulted in a significant growth in public sector savings, to 16 percent of GDP in 1988, leaving room for significant capital expenditures, the elimination of all remaining arrears and an increase in net foreign reserves.

Sound fiscal policy was complemented by a coherent development strategy aimed at reducing the economy's dependence on the banana sector, Mr. Menda said. Private sector involvement in manufacturing and the tourist industry, together with government incentives and improvement in the existing infrastructure, was a sound approach to diversification. The authorities' public investment program was supported by significant amounts in concessional loans, and the debt-service ratio would remain quite low. He concurred with the authorities' intent, expressed in Mr. Noonan's statement, not to develop the phenomenon of "enclave tourism." He would appreciate it if the staff could comment on the steps to be taken in order to achieve that objective.

As to monetary policy, he fully shared the Government's concern about the inflationary threat resulting from the rapid growth in public capital expenditure, Mr. Menda stated. He asked if the staff could elaborate on the instruments available to restrain monetary expansion in the framework of the Eastern Caribbean Central Bank. In particular, he inquired how a more active policy could influence the level of interest rates.

Mr. Shaffrey said that there had been some positive developments in the St. Lucian economy since the Board's discussion of the staff report for the 1988 Article IV consultation, one of the most welcome being the clearance of external arrears. More generally, the authorities were to be congratulated on their continued prudent management of the economy, particularly in the area of fiscal policy. The high level of public sector saving was especially noteworthy.

The good performance in respect of public sector savings would have to continue if the country's infrastructure was to be built up to underpin the broadening of the economy that seemed so necessary, given the outlook for the banana crop, Mr. Shaffrey continued. Although prospective developments in the EC market did create some real apprehensions for relatively uncompetitive producers like St. Lucia, Appendix I to the background paper indicated that yields could be improved. In combination with some basic reforms, the impact of 1992 would be reduced substantially. In fact, he wondered whether rationalization of the banana industry to increase the returns to scale could release extra manpower to both the planned public works projects and the tourist industry. If that were the case, it might also help relieve the upward pressure on wages.

Returning to the need to develop the infrastructure, he welcomed the authorities' acknowledgment of the risks of overheating the economy if too ambitious a program were undertaken, Mr. Shaffrey said. On balance, the projected outcome of a fiscal deficit of over 6 percent of GDP appeared to be a reasonable outcome--particularly as its financing seemed assured; in that context, he presumed that the authorities were well aware that deficits of that magnitude were not sustainable and that a speedy return to fiscal equilibrium was important.

Tourism did seem to be the most promising prospect for increasing St. Lucia's foreign exchange earnings although the authorities should not neglect other activities, given the vagaries of the tourist trade, Mr. Shaffrey observed. Over the medium term, the authorities should aim at minimizing the current account deficit by providing the appropriate environment for the growth of exports and tourism, while ensuring that domestic demand was kept within reasonable bounds. In those circumstances, St. Lucia's external position would remain viable and the low debt-service burden would be preserved.

Mr. Newman made the following statement:

St. Lucia's recent experience demonstrates that a small, open economy can prosper without an independent monetary and exchange rate policy, despite its vulnerability to external shocks. However, certain important conditions must exist for this serendipitous outcome. First, the authorities must pursue a flexible but cautious fiscal policy and respond quickly to changes in the external environment; second, a well-conceived program of structural reform and diversification is needed to provide alternative sources of growth when the main sector experiences a slump; and third, substantial external financing, preferably on concessional terms, must be available. What is not so clear is whether St. Lucia's experience can be duplicated in other countries where the magnitude of the fiscal adjustment and external financing needs are much larger, and the scope for structural reform more constrained.

The authorities have pursued a prudent fiscal policy, combining expenditure restraint and increased revenue to produce a sizable surplus that has permitted a further reduction in net domestic debt, the liquidation of all arrears, and a buildup of foreign reserves. It will be important to maintain an adequate cushion in view of the economy's continued vulnerability to outside events and avoid building in a level of expenditures that cannot be sustained in the lean years. In this connection, we welcome the more restrained public sector wage policy in the current budget but would caution that the recent boom/bust cycle in public pay settlements could exacerbate future problems if the next upswing were to occur during a period of financial weakness or tighter demand conditions. Similarly, it will be important to assure that future development projects are economically viable and fully financed from external sources to avoid creating financial strains.

A major benefit of St. Lucia's participation in the Eastern Caribbean Central Bank has been a moderate inflation performance compared with other Latin American countries. The recent increase in inflation is therefore disturbing, and we welcome the tightening of bank liquidity and the authorities' intention to sterilize a portion of capital inflows as a means of curbing price pressures. The moderate rise in public sector wage settlements and the authorities' willingness to allow increased immigration should also help to restrain increases in wage costs in the private sector where capacity constraints are emerging. We would, however, appreciate staff comments on the reasons for the wide differences between interest rates on deposits and loans which suggests financial market imperfections that could inhibit implementation of monetary policies.

The substantial increase in the current account deficit in recent years is a matter of concern, especially in view of the uncertainties regarding future capital flows and access to markets for traditional exports following European integration. The staff's medium-term projection of a declining current account deficit relative to GDP depends importantly on the success of current efforts to develop the tourist industry. While arrivals and occupancy rates have increased, and capacity is growing rapidly, the flow of tourist revenue is also subject to considerable uncertainties. In these circumstances, the authorities' effort to increase reserves is extremely prudent and welcome. The relatively low level of debt-service obligations also provides some flexibility, although we would caution against depending on debt financing in the present financial environment.

In conclusion, St. Lucia has come through recent economic difficulties in a much stronger position that should enhance its ability to deal with the inevitable uncertainties facing the country over the next few years. We applaud their efforts which stand as an excellent example for other, possibly less fortunate, countries.

Mr. Ichikawa noted that the economic recovery of St. Lucia after 1988 had been accompanied by an improvement in the external balances and a restoration of price stability. The key to that commendable success had been the increase in public savings resulting from the strengthened revenue performance. While strong pressures on expenditure emerged in 1989, including an exceptional expansion of the wage bill and a larger capital outlay, the growth in expenditure had been more than offset by an improvement in tax collection. He also welcomed the fact that fiscal consolidation had led to the elimination of external payments arrears. He encouraged the authorities to continue the favorable fiscal surplus in order to permit the total elimination of taxes on foreign exchange sales.

In that regard, his chair broadly agreed with the staff's appraisal and had only a few comments to add. The strong boom, particularly in construction, in tandem with the limited labor force, led to concern that the recent pressure for wage increases might exceed the economy's capacity, Mr. Ichikawa remarked. He hoped that public sector wage settlements would have a favorable impact on private sector wages. The authorities needed to monitor the release of project-related disbursements from the capital budget carefully, in order to avoid overheating the economy. In that connection, he shared their concern about the recent credit expansion and welcomed their decision to sterilize the buildup of reserves by accumulating balances abroad.

The uncertainty surrounding the export sector was another possible source of concern, Mr. Ichikawa said. St. Lucia's export price of bananas was not competitive by international standards. While there might be preferential transitional treatment even after 1992, the authorities needed to promote economic diversification seriously. Tourism was the most promising industry, and private investment should be encouraged in that and related sectors. In conclusion, the authorities should not depart from their current prudent financial stance, as financial stability and the strong reserve position were the most important ingredients of a favorable investment environment.

The staff representative from the Western Hemisphere Department said that the authorities realized that the back-pay element in the 1989 public sector wage increase, the first since 1985, would have a strong impact on public finances. However, their strategy was to allow a sizable retroactive wage payment in 1989 when they were in a fiscal position to afford it, but gain by negotiating a six-year agreement with a moderate increase for the following three years of only 3 percent a year, well below the expected rate of inflation.

Concerning monetary policy, particularly credit expansion and the role of the ECCB, the ECCB's charter gave it the discretion to use most of the tools of monetary policy common to central banks, the staff representative continued. However, it had opted to use them sparingly and had sought to minimize differences among member countries in interest rates and legal reserve requirements because they wanted to harmonize monetary policy among members, so as to avoid capital flight from one country to another; capital flight could easily occur because of the common currency. Therefore, the commercial banks had been free to determine both deposit and borrowing rates. The reason for the large spread was twofold. First, financial markets were very small and there were few banks; hence, elements of monopoly certainly existed. Second, owing to the small scale of operation, their fixed costs were relatively high. Thus, they needed a wider spread between borrowing and lending rates than was customary in larger and more developed financial systems in which economies of scale could be achieved. However, growth in operations had enabled them to reduce the spread by raising deposit rates while leaving borrowing rates unchanged. Commercial banks in three or four other Eastern Caribbean countries had likewise narrowed the spread by increasing deposit rates.

Banana prices had been good and the crop had a much quicker turnover than possible alternative crops such as coffee or cocoa, which had an investment horizon of four or five years, the staff representative explained. Thus, diversification currently was not profitable. Only declining banana prices would encourage marginal farmers to diversify.

The upward pressure on private sector wages, particularly in the construction sector, was partly the result of credit expansion by the commercial banks to finance residential construction, the staff representative commented. Banks had financed that credit expansion beyond the growth of private sector deposits by reducing their net international reserves, which were at a relatively high level. The authorities, if necessary, were prepared to allow the temporary inflow of labor, particularly of skilled labor, to avoid inordinate increases in wages in the construction sector.

A number of studies had been made on regional issues, the staff representative said. One study by the World Bank, in cooperation with the Fund staff, was among those presented to the recent Caribbean group meetings on medium-term prospects for the Eastern Caribbean. In addition, other studies on trade and CARICOM were being prepared in cooperation with the Fund.

The Chairman made the following summing up:

Directors were in broad agreement with the staff appraisal. They noted that the growth of real GDP in the last two years had been satisfactory, inflation had remained within acceptable limits, and unemployment had declined.

Directors commended the authorities for their prudent fiscal policies of recent years which had facilitated a large increase in public sector savings, the elimination of both external and domestic government arrears, a reduction in the public sector's domestic debt, and a buildup of foreign reserves. Directors noted that the strong revenue performance had not depended on increases in tax rates, but instead on an improvement in tax administration that was to be commended.

Directors welcomed the efforts of the authorities to contain current government outlays. They observed that the wage agreement reached with civil servants would contribute in 1990-91 to the maintenance of a sound fiscal policy, and would provide helpful guidelines for the private sector. A moderation of labor cost increases would be important in assuring an adequate competitive position for St. Lucia. Directors endorsed the policy of accumulating foreign reserves, which would help the Government cope with uncertainties facing banana exports after 1992.

The existing constraints on the use of monetary policy and the common exchange rate arrangements strengthened the need for the continuation of the Government's sound fiscal policies. Directors agreed with the authorities that a slowdown in the pace of credit expansion, such as for construction, was now desirable in order to avoid the overheating of the economy. The large differences in deposit and lending rates practiced by commercial banks suggested that steps could be considered to improve the efficiency of financial intermediation.

Directors noted that the emphasis given to developing the economic infrastructure was appropriate since it underpinned the Government's strategy of fostering private sector growth and diversification, such as toward tourism. However, they noted the importance of keeping the rise in public investment in line with the economy's absorptive capacity to avoid pressures on resources.

It is expected that the next Article IV consultation with St. Lucia will be held on the 24-month cycle.

4. PANAMA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered a staff paper on the further review of Panama's overdue financial obligations to the Fund, following the declaration of Panama's ineligibility to use the Fund's general resources effective June 30, 1989 (EBS/90/100, 5/25/90).

Mr. Kafka said that his Panamanian authorities had no basic objection to the staff paper, although they found some of its comments to be somewhat grudging. For instance, since the most recent review of Panama's overdue obligations to the Fund, on April 20, Panama had made, in a short period of 30 days between April 23 and May 23, two payments to the Fund totaling SDR 18.7 million. The staff mentioned the present amount of arrears to both the World Bank and Inter-American Development Bank, but failed to comment that during the same 30-day period, Panama had made payments in the amount of $42 million to both institutions combined.

The staff representative from the Treasurer's Department indicated that the SDR 6.5 million payment by Panama in May would be used first to clear all arrears in the SDR Department. As a result, the Managing Director's complaint under Rule S-1 could be withdrawn (see EBS/90/99, 5/30/90).

Mr. Dawson noted that the Panamanian authorities were clearly making a strong effort to normalize relations with the Fund and other international financial institutions and to adopt economic policies to deal with the serious problems confronting the country. By any reasonable standard, Panama was cooperating with the Fund, and its policies and payments performance compared very favorably with that of most other arrears countries.

He warmly welcomed the latest payment to the Fund, which met the authorities' commitment to stay current on all obligations falling due after May 1, 1990, Mr. Dawson said. Indeed, payments received so far in 1990 accounted for about 85 percent of all obligations falling due to the General Resources Account since the end of 1989. That far exceeded the performance by most other arrears countries and demonstrated the very high priority that the authorities gave to meeting their Fund obligations.

As the Executive Board was aware, efforts were also under way to deal with the roughly $520 million of Panama's pre-1990 arrears to the international financial institutions. Panama had set aside $130 million in scarce resources as a contribution to the arrears clearing effort. Legislation signed by President Bush on May 26 provided an additional $130 million in net new resources for that purpose. The United States had also agreed to provide a bridge loan of up to $150 million. In the near future, the U.S. authorities expected to be able to establish a support group that could complete the financing package. They hoped that it would be possible to reach agreement quickly.

The adoption by Panama of a budget for 1990 represented a critical first step in developing a comprehensive economic program to deal with the country's problems, Mr. Dawson stated. He welcomed the indications that a Fund mission would be leaving shortly to discuss economic policies that could form the basis for Fund support. The willingness of the authorities to adopt tough fiscal measures to reduce expenditures and raise revenues in the 1990 budget was a positive development that augured well for the future. He urged the authorities and the Fund to move ahead expeditiously to implement a program that would begin the process of reform and rehabilitation of the economy and serve as the basis for clearing international financial institution arrears.

In light of Panama's performance on payments and policies, the proposed decision seemed to take a rather cautious approach, Mr. Dawson commented. At a minimum, he would have expected that the recent payments would have been warmly welcomed, that the upcoming mission would have been noted, and that language similar to the recent Guyana decision calling on donors to provide financial assistance would have been proposed. He would have specific suggestions on each of those points when the decision was considered.

Mr. Appetiti noted that Panama has been making significant efforts to improve its relations with the Fund and to tackle its economic problems. Recently, there had been signs of the authorities' willingness to cooperate with the Fund in many respects. The two payments made in April and May had covered all the obligations falling due to the Fund during those two months, and had somewhat reduced the previously accumulated arrears. The authorities' intention to remain current on the obligations falling due had been illustrated in May, and had been reinforced by the provisions for the payments to the multilateral institutions made in the budget recently approved by the legislative assembly. One other meaningful token of the authorities' good intention was the budget provision for $130 million to be used for repayment of arrears. Finally, in their efforts to find a solution to their economic difficulties, the authorities had invited the staff to visit Panama in June, to discuss economic measures that could be supported by the Fund once the arrears had been cleared.

He could therefore agree with the staff that taking into consideration the peculiar political difficulties faced by the authorities, the application of remedial measures or even its mention in the decision would be inappropriate at the current time, Mr. Appetiti said. Nonetheless, he stressed, Panama's arrears to the Fund remained high at SDR 182 million, and continued to place a burden on the rest of the membership. The good intentions of the Government needed to be followed by additional substantive actions, since much remained to be done to redress the troubled economy and to clear the arrears to the Fund. He therefore urged the authorities to take full advantage of the imminent Fund mission and to adopt and implement a comprehensive set of adjustment measures. He also urged the Government to give the highest priority to the prompt and full clearance of overdue obligations to the Fund and to make every possible effort to that end. The next review of Panama's overdue financial obligations would take place in three months' time--three months that would be crucial for all the Government's good intentions to cooperate with the Fund to bear fruit.

He supported the proposed decision, Mr. Appetiti concluded.

Mr. Goos welcomed the recent efforts of the Panamanian authorities to normalize their relations with the Fund and the clear signs of their intention to cooperate actively with the Fund. However, he was disappointed that only limited progress had been made in the implementation of a comprehensive adjustment program and in the settlement of the arrears to the Fund. Delays in the normalization of Panama's relations with the Fund were not only inconsistent with the cooperative spirit of the Fund, but also were bound to complicate the task of stabilizing and reviving the economy in the face of the rising adjustment costs that resulted from such delays. He took some comfort from the signs of cooperation, in particular the authorities' intention as noted in the paper to discuss with the forthcoming staff mission the economic policies that could form the basis for a comprehensive adjustment program, and the intention to mobilize the necessary financing to clear the existing arrears. He urged the authorities to bring about an early solution to those problems.

He could support the thrust of the proposed decision, and was ready to discuss any amendments to the text, Mr. Goos indicated. It would be appropriate, he considered, at least in the follow-up communication to the authorities if not in the decision, to make a reference to the possibility that in the absence of tangible progress by the time of the next review, the Board might indeed need to consider the adoption of remedial measures. After all, the next review, which he of course hoped would not have to take place, would constitute the fifth time that the Board would have to examine Panama's overdue financial obligations to the Fund. There were precedents for adopting further remedial actions in addition to the declaration of ineligibility at that point.

Mr. Cirelli said that it was very encouraging to note that, after the most recent payments made by Panama in April and May, the level of arrears had been stabilized. He recognized the efforts made by the Panamanian authorities, and welcomed the authorities' intention to repay all obligations falling due. Nevertheless, given the important amounts of Panama's arrears to multilateral institutions, a favorable and definitive outcome was only possible if Panama adopted and implemented a set of strong economic measures aimed at reinforcing the country's ability to belong once again to the international community.

Thus, he could not but agree with the staff report that the actions taken so far by the authorities regarding the adoption of economic policies, and therefore payments to the Fund, could be judged as falling short of expectations, Mr. Cirelli continued. Consequently, he urged the authorities to strengthen their current stance in order to allow prompt reduction of their arrears.

Regarding the decision itself, Mr. Cirelli indicated that he was ready to discuss any amendment. He would have preferred that the message of the needed strengthening of the economic policies be underlined in the decision instead of repeating the language of the April decision.

Mr. Adachi welcomed the positive developments that had taken place since the last review, in particular the approval of the budget by the Panamanian National Assembly, since fiscal policy was the only effective macroeconomic policy instrument for Panama, where the currency was the U.S. dollar. Nonetheless, he had been disappointed to learn that the mission that had been scheduled to be in Panama at the moment had been postponed to mid-June. Because the situation in Panama remained precarious, the new budget urgently needed to be scrutinized. The revenue projections, in particular, were a source of concern. He therefore urged the authorities to expedite their work with the staff and to reach a satisfactory agreement on the economic program. In that context, he would like the staff to elaborate on the reason for the postponement of the mission.

While he welcomed the two payments made by Panama since the last review, it was disappointing that Panama had not yet repaid the full amount appropriated by the National Assembly, Mr. Adachi said. Panama's payment record clearly fell short of the Fund's expectations. He would welcome the staff's comment on the timing of future payments that the Panamanian authorities had in mind.

Since a mission was going to Panama in June, Mr. Adachi agreed that remedial measures were not currently warranted. Therefore, he supported the proposed decision as it stood.

Mr. Sarr remarked that the most recent developments showed some encouraging signs that the authorities were facing up to the difficult task of economic reconstruction. A budget had been approved in late April and strong efforts were already under way to ensure that the budget's objectives were met. The banking system was currently in the process of being fully liberalized and a timetable for the implementation of structural measures in key sectors would be decided on soon. Moreover, despite the continued economic difficulties, Panama had managed to make two important repayments to the Fund. Therefore, he agreed with the staff recommendation that the application of remedial measures at the current time was inappropriate, and he encouraged the authorities to adopt quickly adjustment measures needed to eliminate their overdue obligations to the Fund.

With regard to the next review, Mr. Sarr supported the timing proposed by the staff. He welcomed the information provided by Mr. Dawson that the U.S. authorities were actively supporting Panama's effort to re-establish normal financial relations.

Mr. Posthumus recalled that the staff paper noted that the Executive Board had emphasized two criteria for judging the extent to which a member was cooperating with the Fund: payments performance and the adoption of appropriate economic policies. Payments performance was indeed improving. However, it was not clear that a conscious effort had been made to introduce appropriate economic policies. There appeared to be strong efforts to contain public expenditure, but separate measures to lift restrictions affecting the withdrawal of savings deposits and to fully liberalize deposits were also essential. In the area of structural reform, too, the authorities were only "planning to decide on a timetable," which was a long way from taking action. Accordingly, without opposing the proposed decision, he wished to express disappointment with the way that economic policies were being implemented.

The staff representative from the Western Hemisphere Department indicated that when the Fund mission had been in Panama in March, it had been tentatively agreed with the authorities that late May might be a suitable time for a subsequent mission. However, in recent conversations, the authorities had indicated their preference for the mission to arrive in the second week of June, because the authorities were completing the necessary statistical work, in particular the cash-flow projections of the Central Government and public enterprises, that would be important for the discussion of the specific performance criteria. The authorities also were studying alternative ways of liberalizing bank deposits and were reviewing the financial position and liquidity provisions of domestic commercial banks to carry out such liberalization without difficulties. Finally, a World Bank mission had just returned from Panama, and the Bank staff had left a number of policy suggestions with the authorities, who had indicated that they would like to have time to study and reflect on those proposals, in particular those in the area of structural reforms, before they met again with the Fund staff. For all those reasons, the Fund staff also thought it appropriate to postpone its mission.

Mr. Kafka thanked Directors for their comments, which he would relate to his Panamanian authorities. On the question of payments, he pointed out that the authorities were unable to make payments with money that they did not have. Only the United States had so far made available the financial assistance that it had promised, and two thirds of the money promised by other countries was still outstanding. He hoped that those resources would soon be made available, at which time Panama would be able to clear its arrears.

Mr. Goos said that he expected that the authorities had the funds at their disposal to make more substantive payments to the Fund, which would have been a clearer demonstration of their intention to normalize their relations with the Fund. From that perspective, he considered Panama's payments performance to be unsatisfactory.

Mr. Kafka remarked that until the rest of the amount promised by other countries for the purpose of paying off the arrears was made available, one would hardly want to censure the authorities for wanting to keep a certain cash reserve.

Mr. Dawson noted that Panama's performance in terms of keeping current was matched by only two other of the arrears countries. While it was disappointing that Panama was in arrears, it was doing well compared with other countries in the same situation.

Mr. Goos noted that the Fund had never adopted a policy that it would be satisfied with the country being current on obligations as they fell due. Rather, the institution always insisted on prompt settlement. Admittedly, the draft decision welcomed the fact that the payment made covered exactly the obligations falling due, but a number of Directors, including himself, had never been happy with such a formulation. He would prefer, in the first sentence of paragraph 2 of the draft decision, the Fund to "note" rather than "welcome" Panama's actions and intentions. While he realized that the proposed language had been used in the previous decision, that had not been his preference.

The Chairman noted that the welcoming in the first sentence was offset by the words "deeply regret" in the second sentence.

Mr. Dawson observed that in previous similar cases, language that "welcomed" positive developments had been used.

Mr. Kafka remarked that he would find it extremely unfair to eliminate the word "welcome," and he would in fact prefer to strengthen the expression, although he would refrain from proposing that.

On paragraph three, Mr. Kafka suggested that the following sentence be added: "The Fund notes the need for appropriate and timely external assistance to support Panama's adjustment efforts, facilitating the elimination of arrears and assisting in the rehabilitation of the economy."

Mr. Enoch noted that in the case of Guyana, which was the precedent for Mr. Kafka's proposed amendment, there had been a policy framework paper prepared, a support group in place, and a full understanding of the overall financing scenarios. In the case of Panama, there were only the very basic rudiments of an economic policy outline. He was concerned that there were no details in the staff paper about Panama's financing needs, the latest details being in the Article IV consultation that the Board had discussed in December 1989, in which it had been suggested in the medium-term scenarios that if sanctions were lifted, Panama would be able to regularize payments to multilateral creditors through own resources within a year. There might be legitimate reasons for revising that position, but he would in any case expect the staff to present financing scenarios. Accordingly, he did not support the inclusion in the decision of an exhortation for financial contributions.

Mr. Kafka said that he did not understand what could be wrong with stating that Panama needed additional financing beyond that which had already been provided by the United States.

Mr. Enoch reiterated that there was no analysis in the staff paper that demonstrated such a need, nor was there an explanation of what the financing would be used for.

The Chairman suggested that a possible alternative solution would be, in his communication with the authorities, to welcome the agreement between the authorities and for a staff mission to take place soon to discuss economic policy and financial scenarios for the following years, which could provide a basis both for a quicker economic recovery and international support as appropriate. Such language would recognize the need for further elaboration of economic policy and the financial scenarios, for increased efforts by the country, and for the support of the international community.

The Executive Board approved the following decision:

1. The Fund has reviewed further the matter of Panama's continuing failure to fulfill its financial obligations to the Fund in the light of the facts and developments described in EBS/90/100 (5/25/90).

2. The Fund welcomes the recent payments by Panama and the indication given by Panama that it intends to remain current on all obligations falling due to the Fund after May 1, 1990. Nevertheless, it deeply regrets the continuing failure of Panama to fulfill its financial obligations to the Fund, which is placing a financial burden upon other members and reducing Fund resources needed to help others. The Fund urges Panama to make full and prompt settlement of its overdue financial obligations and stresses that settlement of these arrears should be given the highest priority.

3. The Fund welcomes the authorities' intention to elaborate and implement an economic adjustment program as well as the steps already taken in that direction, and urges Panama as a matter of urgency to adopt and implement a comprehensive set of adjustment measures. The Fund attaches great importance to cooperation with Panama and reiterates its readiness to assist Panama in finding appropriate solutions to its economic and financial difficulties.

4. The Fund will review the matter of Panama's overdue financial obligations to the Fund again at the time of Executive Board consideration of the authorities' economic and financial package or not later than August 30, 1990, in light of the actions taken by Panama in the meantime in meeting its payment obligations to the Fund and in adopting and implementing a comprehensive adjustment program.

Decision No. 9444-(90/83), adopted
May 30, 1990

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/90/82 (5/25/90) and EBM/90/83 (5/30/90).

5. BARBADOS - 1990 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board agrees to extend the period for completing the 1990 Article IV consultation with Barbados to not later than May 30, 1990. (EBD/90/158, 5/24/90)

Decision No. 9445-(90/83), adopted
May 29, 1990

6. ISLAMIC REPUBLIC OF IRAN - 1990 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted

April 29, 1977, as amended, the Executive Board agrees to extend the period for completing the 1990 Article IV consultation with the Islamic Republic of Iran to not later than June 8, 1990. (EBD/90/162, 5/25/90)

Decision No. 9446-(90/83), adopted
May 29, 1990

7. ST. LUCIA - 1990 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board agrees to extend the period for completing the 1990 Article IV consultation with St. Lucia to not later than May 30, 1990. (EBD/90/157, 5/24/90)

Decision No. 9447-(90/83), adopted
May 29, 1990

8. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 89/127 through 89/130 are approved.

9. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/90/133 (5/25/90) and by an Assistant to Executive Director as set forth in EBAP/90/134 (5/25/90) is approved.

APPROVED: April 18, 1991

LEO VAN HOUTVEN
Secretary