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Minutes of Executive Board Meeting 89/164

3:00 p.m., December 15, 1989

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

| Executive Directors | Alternate Executive Directors |
|---|---|
| | C. J. Jarvis, Temporary |
| C. S. Clark | |
| Dai Q. | |
| | A. Rieffel, Temporary |
| J. de Groote | |
| | J. M. Jones, Temporary |
| | S.-W. Kwon |
| E. V. Feldman | P. O. Montórfano, Temporary |
| | G. García, Temporary |
| | A. Fanna, Temporary |
| | M. A. Ahmed, Temporary |
| | C. Björklund, Temporary |
| | M. A. Hammoudi, Temporary |
| | H.-J. Scheid, Temporary |
| | S. P. Shrestha, Temporary |
| B. Jalan | S. Gurumurthi, Temporary |
| | G. Bindley-Taylor, Temporary |
| | G. Serre, Temporary |
| | J. A. K. Orleans-Lindsay, Temporary |
| | Z. Iqbal, Temporary |
| | P. Kapetanovic, Temporary |
| | K. Ichikawa, Temporary |

L. Van Houtven, Secretary and Counsellor
M. J. Primorac, Assistant

Also Present

IBRD: J. B. Sokol, Latin America and the Caribbean Regional Office. Asian Department: H. Neiss, Deputy Director; P. Gotur, H. C. Kim. C.-H. Wong. Exchange and Trade Relations Department: A. Basu, E. Brau. IMF Institute: M. G. Martin. Legal Department: P. L. Francotte, J. K. Oh. Treasurer's Department: D. Williams, Deputy Treasurer. Western Hemisphere Department: J.-P. Amselle, S. Kawar, W. E. Lewis, J. E. Zeas. Advisors to Executive Directors: J.-L. Menda, A. Raza. Assistants to Executive Directors: J. Gold, L. Hubloue, C. Y. Legg, G. Montiel, Shao Z.

1. DOMINICA - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with Dominica (SM/89/248, 11/21/89). They also had before them a background paper on recent economic developments in Dominica (SM/89/254, 12/4/89).

Mr. Clark made the following statement:

> During the second half of the 1980s, Dominica has made considerable progress in consolidating its public finances, in reorganizing its external debt, and, generally, in putting the economy on a path of strong economic growth. In November 1989, Dominica successfully completed the third year of a program under the structural adjustment facility. At present, my authorities do not intend to request additional assistance from the Fund, but they wish to inform the Executive Board that they plan to continue to pursue policies that will build an environment conducive to private sector investment and the diversification of the economy.
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> As noted by staff, the broad objectives of the economic program supported by the structural adjustment facility were achieved, and all but two of the benchmarks were observed. The first of these benchmarks relates to the delay in enacting wage-bargaining legislation. My authorities feel that they need additional time to explain this legislation to the trade unions and to persuade them of its merits. In the earlier part of the decade, Dominica experienced turbulent labor relations, and my authorities are of the view that preserving the more peaceful environment of the past several years through discussions and dialogue is worth the cost of temporarily delaying the implementation of this legislation.
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> The second benchmark not observed was the completion and implementation of the organization and management exercise. This was caused, in part, by the need to undertake extensive reviews of staffing requirements, but was also a deliberate response to the exercise's conclusions that some positions were redundant, while other positions were significantly underpaid. My authorities have decided that it would be best to reduce gradually the size of the civil service by attrition. Moreover, although the implementation of the organization and management exercise would result in considerable fiscal benefits over the long term, my authorities feel they cannot afford the substantial short-term fiscal costs at the present time.
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> The progress that has been made under the structural adjustment arrangement in consolidating public finances, in reducing external imbalances, and in improving the external debt structure, were made in the context of vigorous economic

expansion and declining inflation. However, notwithstanding the good performance of Dominica over the past few years, 1989 has been a difficult year. The major problems are related to the decline of banana prices and the damage caused by hurricane Hugo. The cost of the hurricane has been estimated to be about one fifth of GDP this year, and the impact of the hurricane will continue to impede growth in 1990. Nonetheless, it is a testimony of the extent to which the economy has been put on sounder economic footing, that despite the two very serious problems that have beset the country this year, the economic situation, and in particular, public finances, have not been put in a situation of disarray.

As a result of the setbacks experienced in 1989, economic growth is forecast to be negative both this year and in 1990. At the same time, inflation is projected to accelerate to 6.5 percent and then gradually moderate. The position of the public sector is also projected to deteriorate significantly, with the current balance forecast to decline from its peak surplus in 1988/89 of 5.6 percent of GDP, to a virtual balance by 1990/91. Moreover, as a result of the expanded government investment program, the overall government deficit before grants is projected to more than double by 1990/91 to 16.7 percent of GDP. This, however, should be viewed in the context of the authorities' good record over the past few years in controlling overall expenditures and implementing tax reform measures. In the period 1985/86 to 1988/89, the share of current expenditures in GDP was reduced by 3.0 percent, while the share of current revenues was increased by 1.6 percent.

A significant deterioration in the external current account is also being projected for this and the coming year with the current account deficit estimated to increase to about 28 percent of GDP in 1989, and to remain at that level in 1990. This rather dramatic deterioration is due primarily to the decline in both the volume and value of banana exports, and should be seen in a medium-term context. For example, by 1992, as imports adjust to more sustainable levels, the current account deficit is projected to decline to about 12 percent of GDP. My authorities wish to emphasize that they view the deterioration in both the domestic and external balances as temporary, until the rehabilitation process following the hurricane is completed and the economy adjusts to lower banana prices.

One of the major challenges that my authorities continue to face is the need to diversify the economy. Despite considerable efforts over the past few years, very little progress has been made in this regard. The Government has attempted to diversify the agricultural sector by providing farmers with extension services and marketing advice. In addition, for commodities with export potential, the Government is offering sales contracts before the initiation of production. The Government is also involved in efforts to facilitate the expansion of manufacturing and the development of a tourist industry. Nonetheless, Dominica continues to depend heavily on the production and export of bananas. This dependence is of growing concern, owing not only to the extreme vulnerability of the banana crop to weather conditions and to increased competition from neighboring islands, but also, in particular, to the uncertainties surrounding the preferential market access in the United Kingdom following the planned move to a single European market in 1992.

My authorities have been disappointed by the sluggish response of the private sector to the overall improvement in the last several years in the macroeconomic environment and to the enhanced business incentives. While they continue to believe that the private sector must be the primary engine of economic growth, they intend to involve the public sector more directly in the diversification effort. My authorities feel that there is room for the public sector to play a role in facilitating private sector involvement by reducing some of the initial risks of larger-scale investments. To that end, they plan to participate in larger-size projects, such as the bulk water export project, with the intention of eventually privatizing such undertakings. My authorities also intend to continue to seek funding, on a grant basis, to build an airport capable of accommodating jet airplanes. This, they feel, would help to develop the tourist industry and to promote the expansion of exports of perishable agricultural goods.

Finally, my authorities wish to express their appreciation for the assistance they have received from the staff over their long period of cooperation, and they look forward to future good relations.

Mr. de Groote remarked that Dominica was an example of a well-managed country, as evidenced by the developments set out in the staff report, namely, reduction in unemployment, moderation of the wage drift in the public sector, an increase in the government surplus, a reduction of the internal debt burden, and important investment efforts in the infrastructure. Dominica also maintained very good relations with the Fund; it was noteworthy that the intention had been expressed not to use Fund resources further. Those were all very attractive features of Dominica's situation.

He would devote his attention mainly to two problems, Mr. de Groote said. First, in which area should further investment activities occur? Where could the country specialize in order to improve its balance of payments performance? That was an important question indeed, since the current account deficit was of the magnitude of about one quarter of GDP. Second, was it really wise to have the currency pegged to the U.S. dollar through the East Caribbean Currency Agreement?

There were several recommendations in the staff report for investment in sectors that would allow the country to improve its balance of payments performance, Mr. de Groote noted. However, he did not consider those recommendations to be very feasible. Bananas were one possibility, but it was not at all certain that the market would be favorable after the European unification in 1992. As far as other agricultural products were concerned, which ones were feasible? Tourism was another possibility, but Dominica had the disadvantage of having black beaches, rather than the white beaches that were commonly preferred by tourists. The last possibility was industry in which the country could use its cheap labor, and in his view that was the most promising area. The example of soap and glove factories that had tried to use the comparative advantage of the cheap labor costs had proven successful. Could the World Bank staff comment on whether it was possible to further expand those sectors to include new types of industries? Perhaps it might be possible to develop some kind of free trade zone where those commodities produced at a lower cost could be sold.

Concerning the pegging of the East Caribbean dollar to the U.S. dollar, the background paper revealed that only 3 percent of Dominican exports went to the United States, with 72 percent destined for the United Kingdom, and the balance to European countries, Mr. de Groote noted. There did not, therefore, seem to be any logic behind the pegging to the U.S. dollar. While such a practice could, at times, be an advantage, in the current circumstances, for example, the appreciation of the East Caribbean dollar during recent months had created problems for export markets. Would it not be preferable to have another pegging system that was more directly related to the composition trade of the country?

Mr. Serre said that, unfortunately, two factors beyond the authorities' control had put a severe strain on the progress already achieved through the program under the structural adjustment facility implemented from 1986 to 1989--the decline of banana export receipts and the devastating effects of Hurricane Hugo. Those developments demonstrated once again the vulnerability of small island economies to external shocks.

The additional financial needs caused by the hurricane would put further pressures on the overall budget during the coming years, Mr. Serre commented. In such a situation, utmost attention should be paid to maintaining the present level of revenues. In that respect, the authorities' intention to avoid implementing additional revenue raising measures until the CARICOM's common import tariff had been implemented should be carefully assessed. Contingency actions such as increasing remittances from abroad could be envisaged. On the expenditure side, he urged the authorities to contain current outlays in order to offset the increase in capital expenditures incurred in repairing the damage caused by the hurricane. The present situation should also provide an opportunity to reactivate the improvement of wage bargaining procedures in order to contain further inflationary pressures. He was pleased to note the cautious approach adopted by the authorities regarding the Government's recourse to the banking system.

The growth prospects for 1989 and 1990 underlined the urgent need to diversify the productive base, Mr. Serre continued. In that regard, the switch to new means of agricultural production after the hurricane and the decision of the Banana Marketing Corporation to lower its procurement price were both welcome. On the other hand, economic growth could also be achieved by improving exportable manufactured goods as well as increasing tourism. However, the sluggish response of the private sector to the prospects for economic diversification was cause for concern. Could the staff comment on the possibility of introducing more incentives to the private sector, perhaps with the assistance of the World Bank?

There was no doubt that the coming two years would be a period of difficult challenges, Mr. Serre concluded. Dominica's good track record observed after the hurricane that had hit the country ten years previously had demonstrated the authorities' capacity to move ahead. Moreover, Dominica's membership in CARICOM would help provide the necessary stability to implement recovery measures. Dominica deserved special attention from the international community to assist the authorities in overcoming the present conditions.

Mr. Rieffel recalled that his chair had, in the past, questioned whether Dominica was indeed facing protracted balance of payments problems and, therefore, whether the country's access to the structural adjustment facility was appropriate. Now that three successive programs under the facility had been completed, he was pleased to note that some progress had been made in addressing the country's structural problems and putting Dominica in a better position to face the uncertainties that lay ahead. In reviewing last year the three-year structural adjustment facility, he noted that progress had been made in some areas while there had been regrettable slippage in others. In particular, he regretted that the system of automatic wage increments had been reinstated. He also agreed with the staff that mobilization of revenues by increasing consumption taxes would be an appropriate way to strengthen the fiscal position in the future.

On Dominica's investment plans, Mr. Rieffel questioned the importance that was being given to an airport project at the current stage in the country's economic progress. He also had some concerns about the Government's intention to seek other large-scale projects that it could support.

Finally, Mr. Rieffel wondered whether some thought had been given to moving Dominica to the bicyclic Article IV consultation cycle.

Mr. Kwon said that as he was in broad agreement with the staff appraisal, he could therefore be brief. Over the years since its independence, Dominica had had a succession of Fund-supported arrangements of one type or another and was one of the few very small members of the Fund to have actively used Fund resources. Dominica had made considerable progress toward putting the economy on a sounder footing.

It was disappointing that that progress had not included the diversification of the production and export base necessary if Dominica was to reduce its excessive exposure to external shocks and to ensure that the good growth performance of recent years was re-established on a sustainable basis, Mr. Kwon commented. The recent deterioration in the banana market and uncertainties relating to export market access had revealed the extent of Dominica's continuing vulnerability to developments in that area. And as if that were not enough, like many other very small countries, its problems were compounded by a high proneness to natural disasters, the most recent example being Hurricane Hugo.

The adjustment process envisaged under the structural adjustment facility therefore still had some way to go, Mr. Kwon continued, and he hoped that notwithstanding the conclusion of the arrangement, the Fund could continue to play a decisive role through the provision of technical assistance and through its regular Article IV consultations.

It bore emphasizing that Dominica was a very small, open economy, Mr. Kwon remarked. The fact that the Government had been able to arrange a reunion of expatriates in order to encourage remittances and foreign investment underlined for him, perhaps better than any statistics could have done, the very small scale on which Dominica dealt. In such circumstances, policy options were severely limited.

The key factor underlying the failure to diversify had been the reluctance of the private sector to take a larger role in the productive sector, Mr. Kwon noted. The Board had come across that problem in other cases, and the solution was far from clear. The staff was right to endorse the authorities' intention to continue offering incentives for private sector activity. He also understood the Government's intention to take a more active role in large-scale investment projects, although the staff's concerns relating to rate of return and early privatization were worth underscoring. There was merit in the staff's proposal that the public sector investment program be redirected to focus more specifically on directly productive activities.

Another factor constraining private sector activity seemed to be the reluctance of commercial banks to respond to the demands of domestic private entrepreneurs for longer-term credit, instead of concentrating their lending on housing and other nonproductive areas, Mr. Kwon suggested. The wide margin between deposit and lending rates, notwithstanding the absence of interest rate controls, suggested evidence of imperfect competition. He noted the staff's suggestions on the need to improve the provision of long-term funds from the social security scheme and insurance funds. However, he would welcome any further insight as to why the commercial private sector had been so unresponsive to private sector demands. Notwithstanding all the uncertainties, experience elsewhere nevertheless confirmed that over the long haul, the private sector could reliably be expected to respond to price signals and appropriate macroeconomic policy settings.

Given the relatively narrow range of policy tools available to the authorities, their ongoing challenge was therefore to ensure that domestic public sector finances were maintained on a sufficiently robust footing in order to ensure that the economy had the necessary flexibility to weather future external shocks, Mr. Kwon stressed. That was particularly important when one considered the heavy import burden likely to be associated with the implementation of the public sector investment program. Accordingly, containing current expenditures and reversing the unfortunate narrowing of the revenue base that had occurred over recent years were essential. Continued fiscal prudence was the key to reducing aid dependency and to ensuring national independence, both financial and otherwise.

Mr. Jarvis recalled that both the staff and Mr. Clark had expressed concern about the dependence of Dominica on banana exports because of the attendant vulnerability to the weather and because of the possible ending of preferential access to the U.K. market in 1992. Clearly, the European Community countries would take into account the effects on small countries like Dominica when they concluded their review of preferential access, but that did not lessen the need for the authorities to continue trying to reduce their dependence on banana exports. Another reason that they might bear that in mind was that banana export revenues to the United Kingdom were fixed in sterling, and since Dominica's currency was the East Caribbean dollar, which was tied to the U.S. dollar, the country's dependence on banana exports also left it vulnerable to shifts in the exchange rate.

He had been interested by Mr. de Groote's suggestion that Dominica reconsider the appropriateness of the link to the U.S. dollar, Mr. Jarvis continued, but of course Dominica's currency's tie to the dollar was the policy of the Eastern Caribbean Central Bank and not its own. To some extent, that also applied more generally to both exchange rate and monetary policy for the Eastern Caribbean islands, and it was perhaps a gap in the Fund's consideration of those countries that there was not more focus on the regional dimension. His chair had suggested at previous meetings that the Eastern Caribbean countries shared common policies and common problems. That view had been supported when Mr. Kwon had mentioned the difficulties of obtaining adequate private sector investment--a problem faced by other small islands that had been discussed recently. Accordingly, he would welcome a study of the Eastern Caribbean Central Bank and, more broadly, the regional problems of the Eastern Caribbean islands.

Mr. García commended the Dominican authorities for their achievements in the past three years under the program. Real GDP had grown above the rate of population growth, unemployment had fallen, public investment had increased, the stock of debt had diminished, and the economic infrastructure of the country had improved. Some of those achievements would be reversed in 1989 and 1990 owing to the hurricane and other external factors beyond the control of the authorities. However, one of the most important economic objectives of the program--diversifying the productive and export base of the economy--had not been achieved.

He agreed that the public sector had an important role to play in efforts to diversify the economy, Mr. García said, but that role should be concentrated on the investment needed to improve the infrastructure and the provision of some public goods that would reduce bottlenecks and induce private domestic and foreign investment. The public sector investment program seemed to address those objectives, although there were some areas of investment that might be more appropriately left in the hands of the private sector, unless perhaps some of the foreign resources to be used in the enterprises were tied to the public sector and did not have an alternative use. He would welcome staff elaboration on that, as well as on the significant decline in foreign grants beyond 1990 revealed in the staff projections. It seemed that Dominica would need to rely on such grants for a longer period, until the efforts to diversify the economy produced significant results.

Finally, Mr. García asked why the authorities did not plan to use Fund resources to ease the financial situation in 1990, particularly when the country might well be eligible for financing under the compensatory and contingency financing facility as a result of the decline in the price of bananas in the international market.

Mr. Bindley-Taylor noted that Dominica had performed incredibly well under its annual structural adjustment arrangements between 1986 and 1988. Real growth had been higher than projected, export receipts were higher than anticipated, particularly in 1986 and 1988, and there was substantial improvement in the fiscal deficit. On the other hand, the external current account balance had improved, but by substantially less than the program targets, reflecting the increase in imports that was necessary to expand production and growth. More important, the external current account deficit had been adequately financed by capital inflows and grants.

The projected outturn for 1989 and the medium term reflected the vulnerability of small island economies to the vicissitudes of nature, economic dependence on a narrow range of primary products, and involvement in trade arrangements that necessitated preferred market status, Mr. Bindley-Taylor said. The expected fall of 1.9 percent in real GDP in 1989 was due almost entirely to the direct impact of Hurricane Hugo on the production of bananas and other crops, together with its indirect impact as the fall in agricultural production constrained output in the downstream industries of transportation and manufacturing. More important, given the time factor involved in the cycle of agricultural production, recovery periods were lagged and were highly dependent on the nonoccurrence of additional natural disasters. Given that hurricanes were annual in occurrence and unpredictable in direction, the country's production base was extremely vulnerable. That vulnerability was heightened by the increase in banana production by neighboring islands, which had reduced export prices, and the great uncertainty concerning banana exports after the creation of a single European market in 1992.

In view of the above, Mr. Bindley-Taylor shared the staff's concern that Dominica move toward the diversification of its production base. That could be encouraged through incentives to the private sector to diversify into other crops and by upgrading public utilities and infrastructure through the public sector investment program.

Any expansion in capital formation would require some fiscal restraint in current expenditure to avoid widening the fiscal deficit and having to source financing from the domestic banking system, Mr. Bindley-Taylor warned. He commended the authorities for their fiscal prudence over the past few years and recommended continued caution in the uncertain future. He also commended the authorities for the cautious approach to the rationalization of manpower requirements for the civil service, as he was aware of the possible negative social impact of sudden changes in employment practices by the state in small open economies that had high unemployment and limited economic activities. Nevertheless, the process for streamlining the civil service and controlling wage increases should proceed, however cautiously.

He noted with some concern the projected deterioration of the external current account in 1989 by 27.5 percent of GDP, as well as in the medium term, Mr. Bindley-Taylor continued. In 1989, that deterioration had been due to a fall in export receipts combined with a rise in imports, the latter primarily owing to a large increase in net credit to the private sector. The lower export returns over the medium term would require some constraint on net credit to the private sector and the building up of reserves for the contingencies that may arise, given the openness and vulnerability of the economy.

Mr. Rieffel remarked that it might be possible to coordinate the Article IV consultation discussions of neighboring countries, such as those in the East Caribbean, so that the Board might consider them at one time.

The staff representative from the Western Hemisphere Department said that public investment in improving the economic infrastructure could be usefully undertaken in the areas of: extending the road system, expanding port capacity; building a cruise ship berth to attract tourism; building storage facilities at the harbor and at the airport; and establishing refrigeration facilities. The reliability of air transport was poor, and agricultural products perished at the airport because of infrequency of flights. The Government was also contemplating investment in a bulk water export project, which involved laying pipelines from the interior of the island in order to export drinking water, and in the building of a large hotel. The staff considered that all those projects could contribute directly to production activities.

As for the currency linkage to the U.S. dollar, the staff representative recalled that the East Caribbean dollar had been linked to the pound sterling until 1976. The change to U.S. dollar linkage had had both beneficial and adverse effects in the period since then. Changing the peg required the unanimous consent of the eight members of the Currency Union, and the interests of the members differed, with those relying heavily on tourism from the North American market naturally being interested in maintaining the peg to the dollar.

The Government had provided specific incentives to manufacturers for the establishment of hotels, both fiscally and in simplifying administrative procedures, the staff representative indicated. The cause of the low direct private investment was primarily the difficulty of obtaining medium- and long-term finance. The staff considered that facilities should be established to provide private medium-term financing in order to overcome the commercial banks' unwillingness to provide such financing.

The airport project was not currently included in the public investment program, the staff representative said. The authorities would pursue that project only if they could obtain financing on a grant basis.

The commercial banks were not responsive to private sector demands for credit because of their perception of the risks involved, the staff representative suggested. There was a deficiency of entrepreneurial talent and a lack of experience in production activities. The banks had therefore preferred to lend for tangible investments in housing or consumer durables, and had been quite reluctant to extend medium-term financing for manufacturing projects, for example. While the differential between deposit rates and lending rates was quite wide, that was the case in all the Caribbean islands.

The staff recognized the regional dimension of the problems faced by the Caribbean islands, the staff representative remarked. The common management of the currency and monetary policy had helped the islands by stabilizing those two elements and shifting the stabilization burden entirely to fiscal policy, with beneficial effects on the growth of the economies.

The decline in grants that was indicated in the staff's medium-term projections was based entirely on donors' present indications, the staff representative clarified. Dominica had not asked for further Fund resources under the compensatory financing facility or through emergency assistance because of the high interest rate on these resources. The public sector investment program was funded to a large extent through grants and very concessional financing, and the authorities had indicated to the staff that they were unwilling to borrow at 8.5 percent or 9 percent for that purpose.

The staff representative from the Exchange and Trade Relations Department said that he had taken note of Mr. Rieffel's suggestion to bring a regional dimension to the Article IV consultation discussions of the Caribbean countries by synchronizing some of the consultations. That possibility, together with the suggestion of regional surveillance would be discussed in the surveillance review paper scheduled for early 1990. In response to a question from the Acting Chairman, the possible sequencing of conducting Article IV consultations one year and performing regional surveillance the next year could involve longer delays between the conclusion of the discussion with a member and the bringing of the report to the Board owing to the staffing constraints. While a solution might be possible, the staff would need to consider the implications. It would also be desirable for the Board to give the staff general guidance on an appropriate regional surveillance focus.

Mr. Clark remarked that given the fact that some of the difficulties pointed out in the discussion could reoccur in the coming year, it might be appropriate for Dominica to remain on the annual Article IV consultation cycle and for the Board to reconsider the possibility of a bicyclic consultation at the following Article IV consultation discussion. He added that even though Dominica was a small country, that did not mean that its problems were not difficult and complex.

The Acting Chairman then made the following summing up:

Directors were in broad agreement with the thrust of the appraisal in the staff report for the 1989 Article IV consultation with Dominica. Directors commended the authorities for the generally satisfactory implementation of the structural adjustment facility program and noted that the objectives pertaining to real GDP and the external current account for the past three fiscal years had been achieved. They also pointed out that the higher rate of economic growth had contributed to lowering unemployment.

It was observed, however, that Dominica's production and export base remained narrow and overly dependent on bananas, partly in reflection of the favorable prices obtained in the U.K. market under preferential arrangements. In both 1989 and 1990, real GDP was projected to decline as a result of the falling export prices of bananas and the damage caused by Hurricane Hugo to agriculture and infrastructure.

Directors were supportive of the authorities' efforts to expand and diversify production and exports by stimulating private sector savings and investment. They encouraged the authorities, with the technical assistance of the World Bank, to concentrate public investment in areas that would enhance private sector activity outside the banana industry. A few Directors stressed that the public sector should in general avoid becoming involved with large-scale, capital-intensive projects.

Directors praised the authorities for their cautious fiscal policy, but observed that a further increase in public sector savings would contribute to the success of efforts to increase public investment and economic growth. Directors agreed with the need to widen the base of public revenue and encouraged the authorities to restrain the growth of the public sector wage bill. They noted that wage restraint and productivity gains would help maintain competitiveness and promote the expansion of nontraditional export activities.

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

## 2. BHUTAN - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with Bhutan (SM/89/236, 11/15/89). They also had before them a background paper on recent economic developments in Bhutan (SM/89/255, 12/4/89).

Mr. Jalan made the following statement:

My authorities are thankful to the staff for the excellent analysis of recent economic developments in the Kingdom. The authorities are in broad agreement with the tenor of the staff perception and recommendations. As the staff has covered the recent developments in an exhaustive fashion, I would briefly highlight some of the important issues.

During the two earlier discussions, Executive Directors generally commended the authorities for pursuing pragmatic and prudent policies which had ensured relatively high growth and financial stability. These policies are continuing and the economy is performing well. Despite the problems associated with a small landlocked country with difficult terrain, the Kingdom recorded a healthy growth rate of 6.3 percent during 1988/89. This is, no doubt, less than the rate recorded during the two preceding years. However, the very high rates recorded during these years were on account of special factors--commissioning of a hydroelectric plant and the setting up of two big manufacturing units. The Kingdom has also been able to diversify its production base. This is reflected in a decline in the share in GDP of agriculture and allied activities and the increase in the share of power generation, services and, to some extent, manufactures. In fact, as the staff has indicated, steady development of the manufacturing sector has already been identified as one of the two priority objectives of the Sixth Plan.

The authorities are only too well aware of the consequences of Bhutan's large fiscal deficit and have already initiated measures to reduce it. On the expenditure side, measures have been introduced to exercise effective control and supervision of government expenditure. On the revenue side, besides simplifying and rationalizing the tax structure, the authorities have also considerably strengthened the tax administration machinery and are actively considering adoption of measures, including introduction of personal income tax and a single corporate profit tax recommended by the Fund's technical assistance mission last year. They are also going ahead with their program of privatizing public enterprises. The proposed higher tariff for electricity exports is expected to add as much as 2-3 points to the revenue/GDP ratio. They sincerely expect to bring down the deficit to more manageable levels.

The authorities have also taken measures to diversify exports in terms of both markets and commodities. Data indicate that the share of exports to countries other than India has already risen from under 1 percent in 1985/86 to an estimated 7 percent in 1988/89. In fact, and as the staff has also pointed out, output of many cash crops and herbal medicinal products has grown in response to the Government's special efforts to develop new exports to third country markets. If the negotiations with the Japanese company to set up a joint project succeeds--and the authorities have no doubts on this score--earnings from third country exports would go up by over $10 million to $15 million annually.

The staff has identified the shortage of human resources as a serious binding constraint, which has limited capacity to absorb foreign aid and ensure adequate operations and maintenance of the infrastructure. Conscious of this problem, the Royal Government has already formulated a long-term development policy for a national work force. The initial difficulties with the reduction of expatriate labor are being overcome. The authorities do not envisage this problem in future.

In view of the logistical constraints in developing third country exports and, therefore, the uncertainty relating to foreign currency earnings, the authorities have deferred the purchase of the second aircraft. With this, and the authorities' sustained efforts to generate convertible currency exports, the medium-term outlook appears comfortable. Even on conservative assumptions of an average growth rate of 6 percent per annum, and a modest growth of exports to third countries, the staff expects the current account deficit to decline from 16.4 percent of GDP in 1988/89 to 6.7 percent in 1993/94. Debt service is likely to drop by 10 percentage points during this period. The convertible currency reserves in months of the following years' merchandise imports would remain in the region of 28 to 29 months.

It is true that part of the foreign exchange reserves have accrued because the foreign aid program also covers local costs. The authorities do not regard this as a permanent source of convertible currency earnings. As indicated earlier, they are vigorously promoting convertible currency exports. They also intend to follow a very cautious external debt policy. In fact, a decision has already been taken that foreign borrowings will be resorted to only for economically viable activities.

The medium-term outlook will depend to a considerable extent on the continued cooperation and support of aid agencies and donor countries. If they remain as appreciative of the efforts being made by Bhutan as they have been in the past, the authorities are confident that they will be able to sustain the high growth rate of the recent period and surpass the staff projections.

Mr. Ahmed made the following statement:

I commend the authorities for their prudent economic management in the period since August 1987, when the last Article IV consultation was concluded. Indeed, Bhutan's impressive economic performance must be viewed against the special circumstances of the Himalayan kingdom. These include its small size; the fact that it is a landlocked country whose geographical access is largely restricted to India; and the difficult terrain, which acts as a constraint on agricultural production and raises transportation costs associated with economic activity. Bhutan is also a country with substantial economic potential relative to its size, and implementation of a few well-conceived projects can, as was the case with the Chukha hydroelectric project, result in a substantial improvement in domestic output, the fiscal position, and the balance of payments. It is these opportunities that the authorities have very successfully capitalized upon in the past and must continue to avail themselves of in the future.

Since for the most part I view the staff report as being an endorsement of the policies pursued by Bhutan, I will limit my intervention to some of the more important policy issues.

The introduction of new tax measures, which became effective on July 1, 1989, represents a substantial improvement in the structure of the fiscal system. The projected fall in the deficit during 1989-90 is welcome. While the size of the 1988-89 deficit is a source of concern, it must, however, be recognized that increases in salaries during the previous year were an essential component of the structural reform of the civil service. Furthermore, the cost associated with the purchase of Bhutan's first jet aircraft must also be viewed in a larger context, as the positive externalities that result from such a purchase are difficult to capture in standard financial analysis. At the same time, I am encouraged by the intention of the authorities to levy personal income tax, and I view the deferred purchase of the second aircraft as being a reflection of the commitment of the Bhutanese authorities to the continued pursuit of cautious financial policies.

With regard to the reforms in the monetary system recommended by staff, while there may be a need to improve the operations of the financial system, I have some doubts on the wisdom of establishing a second commercial bank now. Any reforms in the financial system ought to be phased in gradually so that the administrative capacity of the financial sector is not overextended. On a more general level, I welcome the emphasis placed on reducing the shortage of skilled manpower, particularly through the expansion of technical and vocational education.

I can endorse the Sixth Plan objective of diversification of exports. In this regard, recent fruit exports to Bangladesh and the ongoing negotiations for export of ferrosilicon to Japan are encouraging developments. Could the staff update us on the status of negotiations with the Japanese company? I have confidence that the authorities will continue to monitor the level of external borrowing and ensure that it is linked with the financing required for viable projects. In view of the country's special circumstances, it is also necessary for the authorities to continue to maintain a high level of reserves. However, I would appreciate staff comment on what it considers an appropriate level, as convertible currency reserves are projected to rise to 20 months of merchandise imports in 1990-91 even with the purchase of a second aircraft.

I am pleased that Bhutan has been able to make good use of Fund technical assistance and would encourage the Fund to continue to provide the authorities with the support that they may request. I am also pleased to note that inclusion of a page for Bhutan in the International Financial Statistics is now a distinct possibility.

Mr. de Groote noted that the Bhutanese economy had done extremely well during the past few years and that the external situation had been radically changed by the entering into operation of the Chukha Dam. He saw three major problem areas: public finance, balance of payments sustainability, and the absence of sufficient trained labor.

On public finance, the staff was right in recommending the introduction of a personal income tax, Mr. de Groote considered. The staff paper indicated that the tax/GDP ratio was exceedingly low, at only 5 percent. Bhutan had had no tax system before joining the Fund, and the Fund had had to assist the country in developing one. Therefore, he strongly supported the maintenance in Bhutan of Fund experts to assist the country in that area. It would be advisable to simplify the company tax, which did not seem to be effective as it stood. In any event, it should not be forgotten that Bhutan was very generously supported by India: about 50 percent of public revenue, or 15 percent of GDP, was covered by Indian contributions. Regardless of its policies, therefore, Bhutan would continue for a long time to rely on Indian support, and it could not be expected that adjustment measures would radically change the situation, necessary though they were. It was a question of a long-term evolution.

It was very desirable, as suggested by the staff, that the country try to expand its nonenergy exports to India and its exports of goods to other countries than India, Mr. de Groote said. The opening of a road to Bangladesh had already opened new possibilities, as had the purchase of the jet airplane. He regretted the fact that the construction of a new power plant had been postponed owing to the proximity of the project site to the neighboring Assam region of India and the political difficulties in that area. The balance of payments position therefore remained highly vulnerable, and he supported the staff's suggestion for further development of competitive sectors and export possibilities.

The shortage of trained labor was a very serious problem, Mr. de Groote noted. Most of the road workers were not native. As he understood it, some restrictions had been introduced on the entry of Indian workers into Bhutan, and he wondered whether that had been a wise decision. Perhaps for a transitionary period it would have been wiser to continue to rely on a labor force that was obviously still ready to assist the authorities.

The staff report suggested very subtly that perhaps the authorities could expand tourism, Mr. de Groote recalled. It was indeed striking that there were only 160 hotel rooms in Bhutan and only about 2,000 people visiting the country every year. But as someone who had been lucky enough to visit the country, he considered Bhutan to be a unique place and understood why the authorities would wish to maintain the authenticity and identity that they had inherited from their prestigious past. Therefore, he would not support at all a recommendation to increase tourism and have Bhutan run the risk of following the example of other countries whose fabric of society had been destroyed by the invasion of tourists. The authorities had to be congratulated for the way that they had been able to protect their religious institutions from being degraded by the proximity of tourists.

On the purchase of an additional jet airplane, Mr. de Groote very much shared the views expressed by previous speakers that one should not consider that issue solely in balance of payments terms. The importance of a connection with the rest of the world, expensive as it might be, could not be overemphasized since it allowed Bhutan to be open to trade contacts with the rest of the world. Given the difficult access to the country, the objective of purchasing an additional jet had to be examined in broader terms. He felt certain that those countries that wished to assist Bhutan would find good reason for continuing to do so, perhaps by helping in the purchase of a second jet.

Mr. Jones noted the degree to which the central policy issues set out in the staff report differed little from those in much larger and very different countries. That served to remind the Board that the most important key to sustained economic progress was a sound fiscal and monetary framework. Of course, Bhutan had its own particular difficulties resulting from its geography, not the least of which was the lack of trade links beyond those with India, which restricted the country's ability to earn convertible foreign exchange. However, the underlying strengthening of the balance of payments and broadening of trading relationships since the last Article IV consultation were encouraging.

The strong growth that had been experienced by Bhutan was also welcome, Mr. Jones said, although growth was currently returning to more normal levels after completion of the large hydroelectric project. He hoped that the project delays noted in the staff report could quickly be overcome. He shared the staff's concern about fiscal and monetary conditions, and in particular, the projected level of bank financing of the budget deficit in 1989, which would be a most unwelcome development. He fully endorsed the report's recommendations on fiscal measures and the development of monetary control tools, but would welcome staff comments on the likely efficacy of monetary policy, given the free circulation at par of the rupee.

The prospects for external viability were clearly finely balanced, Mr. Jones observed, although the first medium-term scenario in the report did seem to take a very cautious view on the prospects for third-country exports. The alternative scenario showed how far that balance could have been upset if the authorities had incurred another large tranche of external debt. That would not seem to have fitted within the authorities' desired cautious debt strategy, and he very much welcomed the news in Mr. Jalan's statement that a further aircraft purchase was to be deferred, although he had not indicated for how long.

Mr. Ichikawa said that he broadly agreed with the staff's appraisal and supported the proposed decision. Earlier in the week, the Board had discussed the successful economic development of Swaziland, which was also a small inland country. The lesson learned from that discussion was that growth prospects were not necessarily limited by geographical disadvantage and dependence on an adjoining economic power, provided that the authorities maintained balanced economic policies. Bhutan was another case that supported that proposition. It had continued commendably high growth over the past several years and was successfully strengthening the underlying structure of its external position through the authorities' conscious efforts to diversify exports.

Nevertheless, Mr. Ichikawa continued, some unfavorable economic developments were casting a shadow over future growth prospects. The increase in domestic demand, which had been accompanied by a sharp widening in the fiscal deficit, had caused a rise in inflation and a rewidening of the current account deficit. To address that issue, as the authorities clearly recognized, vigorous efforts to restore the fiscal balance were needed on both the expenditure and revenue sides. Mr. Jalan's statement elaborated the authorities' efforts to date in that area, but further efforts were important. He hoped that monetary policy would play a more active role in achieving the macroeconomic target.

The sharp increase in the commercial debt service payments after 1990/91 was a source of concern, Mr. Ichikawa noted, in view of its possible impact on the currently weakening economy. The authorities were encouraged to restore Bhutan's domestic economy, while establishing a workable debt management policy to cope with that new challenge.

Mr. Dai said that he was in general agreement with the main thrust of the staff report, and would therefore make a few observations. He commended the authorities for their economic achievements in recent years. It had not been an easy task for Bhutan to maintain an average growth rate of about 7 percent since the beginning of the 1980s, given the country's limited economic base, shortage of human resources, and high external dependency. By international standards, that was a relatively high rate of growth for a low-income developing country, not to mention the unusually high rate of 18 percent in 1987.

Apart from the authorities' generally pragmatic and prudent financial and development policies, Mr. Dai noted, substantial foreign aid--comprising official transfers and concessional loans--appeared to be an essential factor in Bhutan's economic development. While it was important to strengthen demand management in order to maintain financial stability and safeguard external viability, one should not forget that Bhutan's dependence on foreign aid was inevitable for the foreseeable future if its development momentum was to be maintained.

The way that the Chukha hydroelectric project had dramatically changed the outlook for Bhutan's economy was very impressive, Mr. Dai remarked. That showed the importance of exerting efforts to tap the economic potential in the development process of developing countries and illustrated the practical realities of mobilizing domestic resources. The project would have far-reaching significance for the economy, but that should not lead to overreliance on a single product, which might have undesirable long-term effects, especially in view of the experiences of some other developing countries. Accordingly, he agreed that while the power project provided a good foundation for industrial development, efforts should be strengthened to promote diversification of exports and the manufacturing sector. Poverty alleviation had to be achieved by promoting balanced economic growth and development, in accordance with the authorities' strategy. To ensure balanced economic growth, sharp swings in the economy had to be avoided. In that respect, the tradition of a cautious fiscal policy stance ought to be maintained.

As in many developing countries, the shortage of skilled labor had posed constraints on the country's economic development, Mr. Dai observed. In order to change the situation, the authorities would have to make a long-term commitment to education and training programs. Nevertheless, in order to meet immediate needs, external technological cooperation and foreign technical assistance, including technical assistance from the Fund and the World Bank, were important ways to mitigate those constraints. He endorsed the proposed decision.

Mr. Kwon said that he was in general agreement with the staff appraisal and had little to add to it. Considering the constraints associated with a small landlocked country in mountainous surroundings, the Bhutanese economy had performed well until recently, and he commended the authorities for their prudent management of the economy. In 1987/88, real GDP growth had reached a record high level, reflecting the effect of earlier investments in the hydroelectric plant and two large manufacturing units, and the overall fiscal sector position had remained stable.

However, that situation seemed to have turned around in 1988/89, Mr. Kwon continued. Economic growth had decelerated substantially, and inflation had accelerated to double-digit levels, while the financial position in the public sector and external account had deteriorated. That unsatisfactory performance was attributable mostly to the purchase of an aircraft and high wage bills for the civil service.

Although the baseline medium-term scenario suggested that the economy could sustain reasonable growth over the next few years without further deteriorating the external balance and debt situation, Mr. Kwon considered that the underlying situation called for a more prudent stance in the management of public sector financing and the external debt. He agreed entirely with the staff that in order to maintain financial stability and safeguard external viability, the fiscal deficit had to be reduced. That would imply increasing revenues by broadening tax bases and restraining budgetary expenditure, including capital outlays. In that connection, he welcomed the authorities' intention to introduce a personal income tax and to defer the purchase of a second aircraft. He also welcomed the decision that foreign borrowings would be resorted to only for economically viable activities.

Prudent fiscal sector management would also require enhancement of the public enterprises' operational efficiency, Mr. Kwon noted. In that connection he encouraged the authorities to continue the established privatization policy. Nevertheless, he shared the staff's view that the policy should be implemented at a pace commensurate with the limited entrepreneurial and management resources available in the private sector.

In order to lessen Bhutan's dependence on the Indian economy, more effort was needed to diversify the economy through the expansion of trade and capital flows with other countries, Mr. Kwon stated. The recent establishment of a transit route through Bangladesh was particularly welcome, and would most likely ease the problem of transport and further contribute to diversification of the economy. Human resource development was essential for industrial sector growth, and he therefore supported the authorities' program for that sector. Human resources was an area where the World Bank and other multilateral and bilateral development agencies could play a more active role in the future. He was encouraged by Mr. Jalan's statement on the progress being made in negotiations with a Japanese company to set up a joint project to produce and export ferro-silicon to Japan, and he hoped that negotiation would be concluded successfully.

The medium-term prospect for the Bhutanese economy appeared to be sound as long as the authorities were ready to return to their earlier conservative stance in the management of the economy, which he urged them to do, Mr. Kwon concluded.

Mr. Shrestha noted that Bhutan's economic performance in recent years had been broadly satisfactory. Despite a slowdown in the growth rate in 1988/89, growth was still impressive. It appeared that the growth rate had stabilized, and the authorities should be vigilant in preventing it from declining further.

Production in the agricultural sector was generally satisfactory, Mr. Shrestha observed. The completion of the Chukha hydropower project had identified potential areas of growth. In the industrial sector, despite rich mineral deposits, operations had been confirmed in only a few sectors. There was scope for expanding the tourism sector. There was huge potential for harnessing hydropower. In addition, the climatic conditions of the country were suitable for producing citrus fruits, which were much in demand in that area of the world.

Development of all those sectors, however, required massive investment, Mr. Shrestha said. Efforts by local authorities to amass such investment as in the framework of the Sixth Development Plan, were one answer, but such a process was time consuming. The alternative was foreign investment. Despite various attractions in the form of tax concessions and repatriation of profits, foreign investors needed guarantees of smooth flows of international trade from the country, which Bhutan was currently unable to provide. One of the countries in his constituency had had similar problems to those of Bhutan, whereby exports of carpet and leather products were being transported by air to Europe and other destinations in order to avoid problems in a transit country, leading to highly inflated transportation costs. Other bulky items, such as cereal products, leather, and jute goods, were lying at the border customs points waiting for approval of the transit country authorities. Did the staff consider such problems to be a future bottleneck in the process of Bhutan's expanded export trade to third countries? The 30 percent cash incentive for exports to third countries could not be due only to the added transportation cost, and was perhaps a compensation for such uncertainties.

The staff representative from the Asian Department said that the role of monetary policy had been limited in Bhutan because of the openness of the economy to India. In addition, Bhutan had the constraint of the rupee being circulated side by side with the domestic currency. However, the proportion of the rupee in the total money supply had been decreasing steadily, and was now at 40 percent.

The only monetary instrument that the Bhutanese authorities actually possessed was moral suasion, the staff representative noted. The reserve ratio, which was not binding, was 3 percent. The commercial banks' excess reserves amounted to some 40 percent, so the reserve requirement was certainly not a monetary policy instrument at the moment. Furthermore, there was no nonbank source of financing for the Government. The budget deficit for 1988/89 was at 10 percent of GDP, and the demand for credit from the private sector was also increasing as economic development proceeded. It was in that context that the staff had stressed the importance of developing monetary control instruments, despite the fact that their effectiveness might be limited. Such development would, of course, take time.

The staff had discussed the reserve level with the authorities, who had explained that since Bhutan was a landlocked small country with logistical difficulties and because of the uncertain prospects for the development of exports to third countries (i.e., countries other than India) they preferred to maintain a comfortable level of reserves, the staff representative from the Asian Department indicated. While the expression of the reserves in months' worth of imports sounded very high, the absolute amount was only $50 million. Similarly, while the staff considered the purchase of a second jet as a very important element, one should not forget that the cost of a jet in Bhutan was equivalent to some 9 percent of GDP.

Mr. Jalan remarked that Bhutan faced many of the problems of developing countries: it was very poor, small, landlocked, hilly, had a shortage of labor, and was a primary producer dependent on agriculture and forestry. Many countries, if afflicted with only one of those problems, would have found it extremely difficult to do nearly as well as Bhutan had done, confronted with the multiplicity of obstacles that he had listed. Accordingly, when one considered the situation of Bhutan, it had to be recalled that most development problems were being faced by that country alone. The authorities had tackled them well, and they would be encouraged to hear the comments made by the Executive Directors and by the staff in their favor.

It was a tribute to the work of the staff that the Bhutanese Government had started a process of fiscal consolidation, export diversification, tax reform, and debt control, Mr. Jalan continued. The technical assistance and Fund missions had been extremely helpful to the authorities, who were most grateful.

Further efforts were certainly required on the fiscal side, Mr. Jalan agreed. However, the difficulties of trying to raise the revenue/GDP ratio in an economy like Bhutan's should not be underestimated. In part, illiteracy was a handicap to introducing the kind of tax reform that would be desirable, and in general it would take some time before a dramatic change would be seen on the revenue side.

On tourism, Mr. de Groote's point was well taken: it was for the country concerned to decide what kind of tourism it wanted to encourage, Mr. Jalan said. Bhutan was an extremely small country in an unusual location, and it was up to the authorities to lead the kind of cultural, social, and economic life that they wished to lead. The Fund had to be very careful not to pressure the authorities on the pace of tourism development nor to change the way of life in that country, which was long established and had served the people well.

The Bhutanese authorities were extremely grateful for the aid efforts made by the international community, Mr. Jalan indicated. The future development of Bhutan relied very heavily on continued support from aid agencies, the World Bank, and the Fund, and he had no doubt that such aid would be forthcoming in amounts even greater than before, simply because Bhutan had done so well under such adverse circumstances.

The Acting Chairman then made the following summing up:

> Directors were in broad agreement with the thrust of the staff appraisal in the report for the 1989 Article IV consultation with Bhutan. They noted that, after two years of exceptional growth of output and exports, the Bhutanese economy had slowed in 1988/89, reflecting the completion of the Chukha hydroelectric project. They welcomed recent improvements in land and air transport and the strengthening of the export base.
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> Directors cautioned that demand pressures stemming from a rapid expansion of domestic liquidity and a sizable budget deficit called for a strengthening of economic policy, especially in view of Bhutan's limited economic base and high import dependency. While noting that special factors had contributed to the unusually large fiscal deficit in 1988/89, Directors expressed concern that the deficit budgeted for 1989/90 continued to be high, and stressed the need for restraint on current expenditure, in particular, on public sector employment and salaries.
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> Directors welcomed the recent steps undertaken to rationalize the tax system, but called for further reforms to expand the tax base. In this connection, Directors encouraged the authorities to act expeditiously on the introduction of a personal income tax and on measures to improve the revenue contribution of public enterprises. Directors endorsed the authorities' recent measures to develop human resources and promote private sector activity and also emphasized the importance of such efforts for further economic development.

To strengthen demand management, Directors also recommended that the Royal Monetary Authority develop its tools of monetary control, and promote a gradual shift to a market-based determination of interest rates.

Directors welcomed the progress in increasing convertible currency exports and urged that such efforts be strengthened. However, given the uncertain prospects for such earnings and, more generally, the fragility of the external position, they urged the Government to limit itself to prudent concessional borrowing. In the current circumstances, it was felt there was a need to be particularly cautious with regard to large foreign exchange outlays, such as those related to the purchase of a second aircraft.

Bhutan will remain on the bicyclic procedure, and the next full Article IV consultation will be completed within 24 months.

The Executive Directors then took the following decision:

1. The Fund takes this decision in concluding the 1989 Article XIV consultation with Bhutan, in the light of the 1989 Article IV consultation with Bhutan conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions described in SM/89/236 are maintained by Bhutan in accordance with Article XIV, Section 2. The Fund encourages the authorities to administer these restrictions in a liberal manner.

Decision No. 9323-(89/164), adopted
December 15, 1989

APPROVED: August 16, 1990

LEO VAN HOUTVEN
Secretary