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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/150

3:00 p.m., September 16, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	W. K. Parmena, Temporary
	C. Enoch
	J. Heywood, Temporary
	Di W., Temporary
	C. S. Warner
	D. C. Templeman, Temporary
	A. Rieffel, Temporary
	J. Prader
	M. Hepp, Temporary
	A. M. Othman
	B. Goos
J. E. Ismael	J. Reddy
	Hon C.-W, Temporary
	L. M. Piantini, Temporary
	J. Gold
Mawakani Samba	K. Kpetigo, Temporary
	I. A. Al-Assaf
G. Ortiz	L. Filardo
	M. Fogelholm
	G. Pineau, Temporary
	G. Serre, Temporary
	G. P. J. Hogeweg
C. R. Rye	
G. Salehkhou	O. Kabbaj
	L. E. N. Fernando
	V. K. Malhotra, Temporary
K. Yamazaki	S. Yoshikuni
	S. Rebecchini, Temporary

C. Brachet, Acting Secretary
L. Collier, Assistant
M. J. Miller, Assistant

Also Present

IBRD: E. C. Hwa, Latin America and the Caribbean Regional Office. African Department: A. D. Ouattara, Counsellor and Director; E. A. Calamitsis, Deputy Director; J. Artus, A. Bourhane, B. Delbecque, M. G. Fiator, M. G. Gilman, C. D. Pham, G. B. Taplin. Asian Department: K. A. Al-Eyd, C. M. Browne, R. J. Corker, M. J. Fetherston, M. Ishihara, S. P. O. Itam, S. M. Schadler, D. A. Scott, S. Watanabe. Exchange and Trade Relations Department: H. B. Junz, Deputy Director; E. Brau, A. P. De La Torre, S. Kanesa-Thasan, A. Leipold, J. P. Pujol, M. H. Rodlauer. Fiscal Affairs Department: A. Cheasty, L. K. Doe. Legal Department: J. K. Oh, J. V. Surr. Research Department: P. R. Masson. Western Hemisphere Department: L. A. Cardemil, R. A. Elson, G. R. Le Fort. Advisors to Executive Directors: E. Ayales, K.-H. Kleine, M. Pétursson, J.-C. Obame, P. D. Péroz. Assistants to Executive Directors: N. Adachi, S. Appetiti, R. Comotto, S. Guribye, M. A. Hammoudi, M. A. Kyhlberg, C. Y. Legg, T. Morita, D. V. Nhien, S. Rouai, G. Seyler, C. C. A. van den Berg, R. Wenzel.

1. VENEZUELA - 1988 MIDYEAR ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/88/149, 9/16/88) their consideration of the staff report for the 1988 midyear Article IV consultation with Venezuela (SM/88/165, 8/3/88).

The staff representative from the Exchange and Trade Relations Department observed that at the previous meeting, some speakers had expressed frustration with the experience under the enhanced surveillance procedure. A review of enhanced surveillance and the possibility of attaching an external contingency mechanism to the procedure would be the subject of a forthcoming staff paper to be discussed by the Board following the Annual Meetings.

Enhanced surveillance procedures had been followed for two countries, Yugoslavia and Uruguay, in addition to Venezuela, and the overall experience would not justify a clearly negative assessment, the staff representative considered. The objective of enhanced surveillance had been to assist members, at their request, in normalizing creditor-debtor relations and in re-entering credit markets in a situation where their adjustment record had been positive and where a hump in debt service obligations had been removed through a multiyear rescheduling arrangement. The Board, under the procedure, would assess the quantified economic program of the member at half-yearly intervals. When the process had been developed, it had been emphasized by many Directors that enhanced surveillance should not result in the Fund, in any sense, becoming a credit-rating agency; rather, the intent was to assist creditors in reaching their own decisions.

Member authorities had mentioned--for example, as stated by Mrs. Filardo in the case of Venezuela--that the process of staff consultations had been very useful, the staff representative noted. A number of Directors had referred to the value of the discussions in the Board and of the summings up provided to the authorities. The process, therefore, was a positive one, and the usefulness of the procedure could be seen in how the advice offered was reflected in the authorities' plans. The member's policy response might not be in the same direction or as timely as the Board's advice would have indicated, but it appeared that the process nevertheless resulted in a degree of response that might not have occurred otherwise. The adverse external circumstances under which the process was taking place should also be taken into account, as exemplified by the case of Venezuela, where the severity of the terms of trade deterioration could not have been anticipated.

The placement of a small bond issue in the international capital markets by Venezuela had been possible only at a very high spread over the London interbank offered rate (LIBOR), and the question had been raised about the implications for Venezuela's debt strategy, the staff representative from the Exchange and Trade Relations Department recalled. The placement in the market had to reflect risk. Venezuela had been experiencing weaknesses in its terms of trade in the oil market; at issue were the adequacy and sustainability of the policy response of the authorities to the adjustment need; moreover, the price in the secondary market for Venezuelan debt had been at about 50 percent of face value. The discount had occurred in spite of Venezuela's excellent record of debt service and probably reflected to some extent uncertainties about future policies on closing the balance of payments gap.

Mrs. Filardo said that she could not agree with Directors who had stated that the Venezuelan authorities had not fully undertaken the recommendations of the Board for the orientation of policy. The Government had been facing the dilemma of choosing between two approaches: gradualism and shock. If it followed the gradualistic approach, it must then decide what policies it should choose, and ideally, all policies would be implemented simultaneously in the right direction. However, the origin of the disequilibrium had to be taken into account, and an external disruption--such as a steep decline in exports, a strong increase in interest rates, or a sharp rise in import prices--would render the shock approach impossible. Venezuela's foreign earnings were dependent on oil, but since 1982 the country had experienced five oil shocks, including a reduction in oil prices in 1988. From a peak of $20 billion, oil income had fallen to $7 billion in 1986, had recovered slightly in 1987, and was falling again in 1988. The oil market had been weak, and its prospects were uncertain.

Various external interest rate shocks had posed an added burden on Venezuela's debt service, Mrs. Filardo commented. Fortunately, the country had a high level of international reserves to cushion the shock. Moreover, Venezuela had implemented a strong fiscal adjustment policy during 1983 and 1984 that had shifted the deficit to a large surplus during 1984 and 1985, but that result had been at the expense of curtailed investment, imports, and growth. Venezuela's GDP had declined for six consecutive years and the labor force had grown by more than 3.5 percent annually--a situation that could not continue, for political and social reasons. Venezuela therefore had initiated a growth-oriented approach that included the diversification of nontraditional exports. Unfortunately, following the initiation of those policies, a second oil shock had occurred in 1986. The Government's subsequent devaluation of the currency by 100 percent had had a significant impact on debt and inflation. Nevertheless, Venezuela remained committed to fulfilling its responsibilities to the international community and to honoring its debt.

Because Venezuela's problems were not short term, the authorities considered the enhanced surveillance exercise useful; it covered a broader horizon and allowed the authorities and the staff to maintain a continuous dialogue that was conducive to reducing discrepancies in the orientation of policies, Mrs. Filardo remarked. Most important, the exercise included the design of a long-term economic program in the context of the medium-term scenario. The Fund staff and the authorities agreed on the approach to the present disequilibria in Venezuela. There was a consensus regarding the need for both a unified and more flexible exchange rate and for positive interest rates. However, some differences of view arose regarding the timing of those policy adjustments, as the authorities considered that implementation would be possible only after the elections. The authorities were preparing a set of recommendations for the next Administration to allow it to better assess the situation and to implement the required policies. Meanwhile, the authorities had moved to reduce the fiscal deficit, consistent with the staff's recommendation. On monetary policy, the Board of the Central Bank, on the previous day, had decided to reduce the money supply growth target from 18 percent to 14 percent. In sum, the authorities had made great progress in undertaking the Board's recommendations, although admittedly they had not adopted all of them.

Venezuela had placed two government bond issues in international markets--amounting to $100 million--but access to capital markets had been slow and costly, Mrs. Filardo observed. The situation arose not only because of the uncertainty regarding the policies that Venezuela would undertake in the future but also because of the broader issue of the debt strategy and the problem of debt. Venezuela was included in the group of 16 heavily indebted countries--at least half of which had not even been able to pay interest--while Venezuela had not had to approach the Fund or multilateral institutions for debt renegotiations.

The operations with the Bank for International Settlements and certain foreign central banks were short term--six months with the possibility of renewal for an additional six months--and one operation was guaranteed, Mrs. Filardo noted. A Venezuelan delegation had traveled to various countries, including Germany, Japan, and the United States, and had determined that it was impossible to obtain funds without a guarantee.

Trade liberalization measures could not be initiated by the Government in an election year in Venezuela, Mrs. Filardo stated. Nevertheless, the authorities planned to undertake a liberalization program, and in that connection the World Bank's comprehensive evaluation of various sectors would be part of the recommendations for structural reform provided by the Government to the next Administration.

The Acting Chairman then made following summing up:

Executive Directors generally agreed with the thrust of the appraisal contained in the staff report for the 1988 midyear Article IV consultation with Venezuela. They commended the Venezuelan authorities' efforts to adjust the economy, restore growth, and maintain good relations with foreign creditors.

Nevertheless, they noted that the limited progress that had been made in tackling imbalances and structural rigidities in the last two years had prevented a reduction in the vulnerability of the Venezuelan economy to external shocks. The decline in world oil prices since late 1987 had further weakened Venezuela's external position and was expected to result in a large balance of payments deficit in 1988. The problems in the external sector were contributing to difficulties in domestic policy management, as reflected in continued inflationary pressures and a widening spread between the controlled and free market exchange rates. Although price pressures were less strong than in 1987, some Directors were of the view that the control of inflation should be one of the priorities of the authorities.

Directors observed that despite the limited room for maneuver afforded by the proximity of the presidential elections, the authorities should adopt a comprehensive economic program that would reduce domestic and external imbalances and thus help to promote higher economic growth over the medium term than now appears to be in store. While in their view, Venezuela could finance this year's balance of payments deficit by drawing down net reserves, the present course of economic policies could not be sustained for long. Indeed, on present policies, medium-term prospects were not altogether encouraging. Directors noted that delays in strengthening domestic policies had already resulted in an accumulation of costly short-term external debt, and that further postponement could lead to a more difficult adjustment later.

Most Directors welcomed the greater flexibility in exchange rate management and stressed that such flexibility would have to be a critical element in the economic program. Directors considered that the multiple exchange rate system had discouraged export development, contributed to speculative activities, and become a source of substantial credit expansion because of the cost to the Central Bank of exchange subsidies. A number of Directors emphasized the importance of moving toward a flexible, unified exchange rate system which, coupled with implementation of the proposed customs tariff reform that had been discussed with the World Bank, would, in their view, facilitate the reduction of quantitative import controls and other trade and exchange restrictions.

Directors emphasized that a reduction of the overall public sector deficit was essential if the authorities were to achieve their targets for inflation and the balance of payments and if they were to make room for an increase in domestic savings over the medium term. Such an increase in domestic savings would permit a durable recovery of private sector investment and sustained economic growth. To this end, Directors underscored the need both to strengthen public sector revenues through increases in prices and tariffs of state enterprises and to limit expenditures for subsidies and low-priority investment projects.

In the monetary field, Directors saw the need for a major revision of interest rate policy. Interest rate ceilings at negative real levels had discouraged savings, promoted the development of "curb" market activities, weakened the effectiveness of monetary policy, and contributed to price and balance of payments pressures. A number of Directors urged the authorities to adopt a flexible interest rate policy that would allow rates more fully to reflect market forces, and in this context they welcomed the authorities' decision to allow government and corporate bond issues at market-determined rates.

Several Directors also welcomed the progress made in liberalizing restrictions on foreign investment, and they considered this an important structural reform. However, Directors noted that further actions were needed to remove structural impediments to growth and economic diversification, including the liberalization of direct controls on prices and foreign trade. Directors were generally of the view that a more liberal approach to pricing policy and foreign trade would have beneficial effects on private investment and resource allocation, and they welcomed the authorities' request for World Bank assistance to devise solutions in these areas.

In reviewing Venezuela's experience under the enhanced surveillance procedure, several Directors expressed the hope that the authorities would give greater weight to the views of the Fund in choosing the policy adaptations under consideration, thereby increasing the credibility of their economic strategy vis-à-vis foreign lenders.

It is expected that the next Article IV consultation with Venezuela will be held within six months.

2. SINGAPORE - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Singapore (SM/88/185, 8/16/88). They also had before them a background paper on recent economic developments in Singapore (SM/88/203, 9/1/88).

Mr. Hon made the following statement:

In 1986, Singapore implemented a wage restraint policy to restore its competitiveness. Following that action, developments in the economy showed a marked improvement. The economy began to expand in 1987, and growth has been especially rapid in the past 12 months. GDP increased at an annual rate of 10 percent in the second half of 1987 and 11.2 percent in the first half of 1988. This surprisingly rapid growth was mainly a result of the better than expected performance of the world economy, the recovery of the long-depressed commodity market which benefited neighboring countries, and a strong revival in the world electronics industry.

Demand conditions continue to be strong. The Singapore authorities expect that the economy will continue to expand in the second half of 1988, although at a slower pace than in the first half. Keeping in mind the uncertainties inherent in making such projections, a growth rate of about 9 percent for 1988 as a whole is now expected.

Exports and imports, in tandem, have also been strong; and as a result, the balance of trade is expected to remain at the level anticipated earlier. Capital inflows seem less buoyant now than at the time the mission prepared its report, as there are signs that residents have been investing more overseas. Official reserve accumulation was only US$0.75 billion in the first half of the year and now seems unlikely to reach the US$3.25 billion projected in the mission report.

With the economy growing so rapidly, tax revenues have also been above expectations. The authorities agree with the staff assessment that a surplus could result in the 1988/89 budget.

It should be noted that the high recent rates of GDP growth cannot continue much longer. Singapore's labor market is now extremely tight, and wage pressures are developing. Soon growth must, of necessity, drop back to around the long-term potential rate, which we estimate at a maximum to be about 6 percent. Labor force growth--including imported foreign labor--is expected to be 1.5-2 percent in the medium term, and we estimate that 3.5-4 percent productivity growth can be sustained. Unlike the wage restraint policy of the previous two years, wage increases have begun and will continue to move more in line with productivity gains. To allow real wages to respond to changing economic conditions, a flexible wage component has been introduced into the current wage structure.

The Singapore authorities have not targeted the current account or reserve accumulation. Before the 1985/86 recession, Singapore had always recorded a current account deficit. This was not regarded as a problem, since it was adequately covered by a corresponding capital inflow. The current account moved into balance during the recession and has recorded surpluses in the past two years. The move toward a surplus occurred when investment fell in the recent cyclical downturn, while the unusually large working-age proportion of the population caused the savings rate to remain high. However, the demographic profile is shifting in a way that will gradually reduce the savings rate in the future. While the authorities have no target for reserves, they do not consider the equivalent of seven months' retained imports as excessive. Rather, the authorities regard the present surpluses and the moderate rate of reserve accumulation as insurance for the nation against external payments problems, should adverse economic developments occur.

To ensure a low and stable inflation rate and to maintain confidence in Singapore as a financial center, the authorities have assigned a high priority to a stable exchange rate for the Singapore dollar. The consumer price index in Singapore rose at an average of 2.2 percent in 1981-87 compared with 5.6 percent in OECD countries and 12.3 percent for the world. While the primary objective of maintaining a stable exchange rate has hindered the conduct of an independent monetary policy, the authorities have, through foreign exchange swaps and operations in the interbank and the government security markets, been able to manage domestic liquidity with a reasonable degree of effectiveness.

The authorities would like to reiterate that the long-term objectives of fiscal policy, as outlined in the budget statement of 1988/89, are to achieve a balanced budget over a five-year planning horizon and to gradually reduce the share of national resources taken by the public sector so as to facilitate private sector growth. The authorities have been closely monitoring the budgetary outcome. They agree that tax adjustments are a possible policy option should surpluses become large and persistent.

With a very small and open economy, subject to shocks beyond its control, Singapore's well-being depends critically on its ability to make timely, necessary adjustments in response to external developments. Singapore has previously demonstrated that it is willing to make necessary adjustments, even very painful adjustments, and to make them rapidly when the need is clear. The authorities remain committed to their previously stated long-term objectives and will make any changes to achieve those objectives at the appropriate time.

Mr. Yamazaki made the following statement:

I welcome this opportunity to discuss one of the most dynamic economies in the world. Following the recession in 1985, Singapore has shown remarkable resilience and the authorities deserve much of the credit for the country's noteworthy economic performance. Moreover, the spillover effect of the intensified policy coordination among major industrial countries has supplemented the authorities' efforts to resume international competitiveness and to stimulate economic growth.

Looking ahead, Singapore will benefit most from the favorable prospects for the world economy. A typically small open economy, it will take the most advantage of sustained world economic growth and stable exchange rate movements. Therefore, the future task for the authorities will be not only to sustain the excellent economic performance but also to contribute to further development of the world economy with its dynamism. In this context, I welcome Singapore's contribution to the enhanced structural adjustment facility.

The medium-term balance of payments prospects are one of the main issues dealt with in the staff report. While I commend the staff for the well-worked-out econometric studies, I hesitate to rely heavily upon medium-term econometric forecasts for the newly industrializing economies, such as Singapore, which started to experience, only a few years ago, drastic changes not only in their economic structures but also in their social structures. Those changes in social and behavioral patterns are inherently difficult for econometric models to capture, and they do not seem to be well embodied in the staff's model owing to data constraints.

I also have some concerns about forecasts for direct investment from industrial countries, especially Japan. Following sharp exchange rate adjustments, Japanese manufacturers relocated their plants overseas. Those structural changes in Japanese industries have boosted Japanese direct investment in Singapore; however, recent stable exchange rates might abate Japanese direct investment. I would welcome the staff's comments on recent Japanese direct investment, especially this year's data.

I sympathize with the authorities' prudent policy stance because, while open economies benefit from external favorable developments, they are also vulnerable to external adverse developments. Having said this, I nevertheless concur with the staff that excessive current account surpluses could have inflationary implications and could also provoke protectionist political movements. Therefore, I welcome Mr. Hon's statement that tax adjustment will be a possible policy option.

Wage restraint and exchange rate depreciation were instrumental in bringing about a recovery in competitiveness. But now that competitiveness has been restored and that recent output growth implies further gains in productivity in 1988, the time has come to modify wage and exchange rate policies. Therefore, like the staff, I welcome the introduction of flexible wage components into the current wage structure, as well as recent exchange rate movements, and I encourage the authorities to take further steps in these directions as necessary.

On fiscal policy, excessive and persistent current account surpluses imply that the authorities should take appropriate action to compress government savings.

The authorities are striving to restructure the economy further toward high value-added activities in the manufacturing and services sectors, and we encourage them to intensify their efforts. The need to diversify products and markets and to upgrade operations is illustrated by the fact that, in 1987, the electronic industry accounted for about one third of value added in the manufacturing sector, or about 12 percent of GDP.

In conclusion, I commend the authorities for having implemented appropriate policies to achieve a superb economic performance, and I wish them future success in macroeconomic policy management and in economic restructuring.

Mr. Salehkhou made the following statement:

Given the prevailing difficult world economic conditions, it is unfortunately a rare, but happy, occasion to have the opportunity to discuss in this Board success stories like that of Singapore. Indeed, it is not our usual practice to advise members to reduce budgetary and external current account surpluses rather than deficits.

The case of Singapore, given the size of the country and of its population, cannot easily be transposed to the cases of other developing countries. It is, however, heartening to note the high level of growth--except for 1985 and 1986--the very low inflation rate, the prudent and efficient conduct of monetary policy, and the good performance of the trade sector despite unfavorable terms of trade. Other favorable elements are the high rate of gross national savings, a sizable overall budgetary surplus except for one year, and an external current account surplus since 1986, while the overall balance of payments has been and continues to be in surplus. Also noteworthy are the more than comfortable level of foreign reserves and the quasi absence of external debt. Last, but certainly not least, Singapore, by accepting the obligations under Article VIII, Sections 2, 3, and 4, maintains an exchange system free of restrictions on payments and transfers for current international transactions.

The authorities are to be wholeheartedly commended for these accomplishments. Most recently, they have again demonstrated their ability to adapt to difficult circumstances by having been able to restore a healthy rate of growth after the only slump of the recent past in 1985. Given this solid track record, I wonder whether Article IV consultations with Singapore could not be put on a 24-month cycle or, if not feasible, on a bicyclical procedure.

I have little to add to the staff appraisal, with which I broadly concur except for the qualifications introduced by Mr. Hon. The staff and the authorities are generally in agreement on the medium-term objectives and on the policies to be pursued. I detect, however, a more cautious approach on the part of the authorities, given the uncertainties in the world economy. In view of the perfect track record of the authorities, I am inclined to follow their advice and to, according to the staff report, "give weight not only to wage and exchange rate movements, but also to such factors as political stability, an attractive and transparent tax and regulatory system, availability of a skilled labor force, and the high quality of supporting services."

Although Singapore is considered a newly industrializing economy and as such targeted by industrial countries for the surpluses generated, I believe that, given the predominance of services in the Singapore economy and the modesty of these surpluses on a global scale, Singapore is not bound to have, as the staff states, a potential for increasing trade frictions.

Mr. Fernando made the following statement:

I join previous speakers in commending the authorities highly for their enviable record of economic management. Timely action to shift domestic demand from consumption to investment, together with improved export competitiveness through control of unit costs, ensured a dramatic turnaround after the 1985 recession. It is pertinent, however, to note that the external environment, characterized by the continuation of the recovery of the world economy, strengthened and speeded up the outcome of Singapore's adjustment effort. We make this point because the staff recommends a reversal of policies on the premise that some overshooting may be occurring. Given the close integration of the Singapore economy with the rest of the world, the authorities have some justification for being cautious, as another faltering of growth caused by domestic developments may not encounter the same favorable external environment when corrective action is undertaken. The world economic outlook exercises do not show that such downside risks exist, but it must be remembered that the world economic outlook projections are not forecasts; rather, they are the external consequences of certain assumptions regarding domestic economic policies, particularly those of the major industrial countries.

The staff's medium-term scenarios show that under unchanged domestic policies, the current account surplus could increase from 4 percent of GNP--or $1 billion--in 1988 to 5 percent--or $2 billion--but only over five years. A more sustainable level at the end of five years would be 3 percent.

The Government is already moving to liberalize the system of wage setting. Also, given the capacity constraints now being reached, the priority being accorded to price stability will militate against further nominal effective depreciation. The authorities should carefully watch these factors evolve and interact with other developments. We are not convinced that an immediate problem exists that would call for the authorities to also start moving on the budgetary front to cut back the external surplus. Budget surpluses and their investment abroad make monetary management easier. Thus, while we agree with the future direction of policy, we emphasize the need for monitoring at this stage rather than for urgent action.

On the policy discussions with the authorities, we commend in particular the efforts of the staff to increase the efficiency of the dialogue by providing several simulation exercises that take cognizance of the authorities' concerns. This is useful in the absence of clear downside or upside risks of exogenous origin. We would like a clarification, however, of the third simulation of the model that was used in making the medium-term projections. According to the staff report, a stronger increase in real wages is associated with a corresponding deterioration in competitiveness and a decline in output growth by 1/2 percentage point. The effect on the external current account is expected to be small because investment, and therefore imports, will also be lower than otherwise. But if real wages increase, a reduction in competitiveness may not necessarily follow if the higher labor cost is absorbed by the profit margin. Thus, although investment and therefore imports would tend to fall, a deterioration in competitiveness could at best be only a long-run phenomenon.

Another point on which comment would be appreciated concerns the labor market and the role of foreign direct investment. About 70 percent of Singapore's domestic exports originate in foreign-owned companies. Singapore had been attractive to foreign capital less for the size of its domestic market than for, among other things, the attractiveness of its labor market for efficient production. Given the tightness of the labor market and the long-term prospects for contraction, one would wonder whether foreign direct investment could fulfill the high expectations. Mr. Yamazaki's observations on the exchange rate and foreign direct investment from Japan are also relevant here, and staff comment would be welcome.

Mr. Enoch made the following statement:

The surveillance of an economy like Singapore's raises very different questions from many Article IV consultations. The conduct of policy--as attested by the enduring success of Singapore's economic performance--has on the whole provided something of a model. As occurred last year, the main issues therefore tend to be more strategic in nature. Such strategic issues will become increasingly pressing in the case of Singapore, as the success of the development policies that served it so well in the past have to be adapted--in large part, because of that success--to sustain continued progress. Structural adjustment is not just a necessary response to previously inappropriate policies or adverse exogenous shocks; it is an ongoing requirement for sustainable development.

In the case of Singapore, development to date has been achieved through the exploitation of comparative advantage in the international economy, guided by market-based policies and financed by strong domestic resource mobilization and non-debt-creating foreign capital. It is important to recognize, however--and staff reports have tended to underplay this point--that market signals have been interpreted and reinforced by close government intervention in the economy. At this stage the authorities recognize the need for greater reliance on market mechanisms in their objective of reducing the relative size of the public sector. Policies such as privatization, restraint on the size of the civil service, and the balancing of the budget over the medium term are appropriate in this regard. Several recent measures have also been particularly important in decentralizing the economy. For example, the devolution of the wage determination process to allow the greater interplay of market signals is a welcome improvement over the previous centralization within the National Wage Council.

One area where there may be considerable scope for reducing the Government's role is financial intermediation. It is hard to rationalize such a continuing role, not least because of the sophistication of Singapore's domestic financial sector. The unnecessary overlap seems to be increasing. For example, the Central Provident Fund has become much more like a private financial intermediary, by financing house purchases and investments in unit trusts, and this trend is likely to continue.

On the external side, a strategic issue that may begin to press on Singapore will be the question of whether it should become a net capital exporter, implying a structural current account surplus. As Singapore consolidates its transformation into an advanced economy, and the private sector comes into its own, it is likely to rely less on the initiative of foreign capital and more on its own innovation. Together with the constraints on labor, this suggests that Singapore could become a major source of direct investment in neighboring economies. A current account surplus to fund capital exports might be an appropriate part of such a process. However, this current account surplus must be a reflection of the private savings-investment balance rather than continued net public savings. Both in this longer-term context and in regard to the immediate question of the budget surpluses projected by the staff, I concur with the staff's doubts about the continued accumulation of official reserves. Whether this immediate issue is best resolved by tax cuts, as the staff suggests, is open to question, given that the economy is already operating above potential. One could argue that at least part of the adjustment should come through some further appreciation of the exchange rate.

These various issues will be interesting to follow in coming consultations. The strong track record of the authorities gives confidence that the authorities will be able to tackle successfully the fundamental challenges they now face. This confidence also suggests that we might consider moving Singapore onto a bicyclic consultation cycle, and I agree with Mr. Salehkhou's comments in this regard. Finally, I thank the staff for setting its analysis of Singapore more firmly in a regional context, as this chair has suggested on previous occasions. I hope that this perspective will be deepened in the next consultation.

Mr. Templeman made the following statement:

Developments since last year's Article IV consultation have reconfirmed the resiliency of Singapore's economy, which has experienced a rapid recovery from the 1985 recession and is experiencing a major transformation in its structure. Indeed, I share the admiration expressed by other members of the Board for the prudent economic management which has contributed to high real growth, minimal unemployment, price stability, fiscal balance, and recently, current account surpluses. Of course, for a small open economy like that of Singapore, the better than expected growth of the world economy and of world trade this year has also played an important part in this favorable outcome.

The weakened competitiveness of the Singapore economy which occurred earlier in this decade has now clearly been reversed. For example, real economic growth exceeded 8 percent a year in the period 1983-84, and it is expected to reach an average of about 9 percent in the period 1987-88. Yet, Singapore's external balance in those two periods was dramatically different, with an average deficit of 2.7 percent of GNP in the first period, compared with an average surplus of 3.3 percent in the second. A number of factors account for this impressive turnaround. Wage restraint in the past two years and exchange rate depreciation have clearly been very important. But we concur with the Singapore authorities in also attributing the strength of Singapore's competitive position to such other factors as a favorable business environment, political stability, a trained labor force, the transparency of tax and regulatory policies, and the existence of a supporting structure of services.

These factors are worth bearing in mind in assessing the role of exchange rate policy. Specifically, a country that offers such an array of advantages is in a good position to permit currency appreciation--when that is appropriate for achieving other objectives--with less risk of a loss in competitiveness and of pressures on its external position. In that connection, the staff report refers to some recent currency appreciation, and the staff and the authorities seem open to appreciation as a policy tool for reducing excessive external surpluses. But the data in the tables and charts do not seem to show much, if any, upward movement. We would welcome further comment on this subject.

The staff report makes a rather convincing case that Singapore is now in the position of having a structural surplus in its savings-investment balance and in its current account position. This mainly reflects the reduced need for major public investment to build infrastructure, coupled with the high public and private savings rate.

Given the authorities' aims of fostering an expansion of the private sector as a source of investment and diversified growth and of correspondingly reducing the role of Government and of public spending, the logical way to bring savings and investment back into closer balance is through tax cuts to reduce public savings. To the extent that we may give credence to the baseline medium-term scenario, the need for reducing the excessive surpluses of savings and of the current account is shown in the steady growth in the ratio of the current account surplus to GNP in Table 6 of the staff report, with the surplus rising steadily to 5 percent of GNP by 1993. Even using somewhat less favorable assumptions, the sensitivity simulations still produce quite high current account surpluses.

It is true that, in global terms, a 1993 current account surplus of $2 billion is not large in absolute terms. But the Fund has a responsibility in its surveillance role to assess and make policy recommendations concerning relatively large external imbalances, regardless of the size of the country or of the absolute size of the imbalance. Of course, it is also important for the member country to perceive that a correction of such an imbalance is in its own economic interest as well as in that of the world payments system. The staff report presents a case worth careful consideration by the Singapore authorities.

This case centers on the adverse impact of excessive surpluses on the achievement of such aims as a reduction in the size of Government, preservation of price stability, reduced vulnerability to external shocks, and the avoidance of commercial conflicts. Thus, a cut in taxes and in excess public savings would contribute to reducing the size of Government and the size of the external surplus. The avoidance of a buildup of external reserves would moderate upward pressures on the money supply and contribute to price stability, as would some appreciation of the Singapore dollar. Reduced reliance on foreign demand owing to an excessively strong competitive position could make the economy somewhat less subject to foreign shocks, and lower surpluses with trading partners should help to avoid trade conflicts and alleviate protectionist pressures.

In addition to fiscal adjustment, wage policy could also play a role in reducing the external surplus. Admittedly, the fairly recent history of excessive wage pressures needs to be borne in mind. But the current tightness of the labor market and the good record and favorable prospects for productivity growth justify some increase in the growth of real wages. This would both reflect the scarcity value of labor and permit the workers to share the fruits of their labor. It would also help to sustain domestic demand, including demand for foreign goods and services. Moreover, a more flexible wage policy would facilitate the shift to more capital- and skill-intensive production, which is an official goal.

We recognize that periods of transition are difficult ones for economic policy officials because of uncertainties about the durability of recent changes and about the response of a new economic structure to policy actions. But the Singapore economy has shown great resiliency and the authorities have shown considerable courage in adapting their policies to changed circumstances. Some policy adaptations are now warranted. Mr. Hon reasserted his authorities' willingness to make necessary adjustments, even painful adjustments, when the need is clear. We take comfort from that assurance.

Mr. Dai made the following statement:

As pointed out by previous speakers, Singapore has had an outstanding record of sound economic management and performance for many years. Although its economy suffered a brief setback in 1985 and 1986, the strong economic rebound of 1987 seems certain to maintain its momentum in 1988. According to the staff report, real growth is projected to remain high at about 8 percent. Domestic demand has continued to provide the main impetus to growth, as private investment increased further in response to the strong growth in exports. The good performance and the favorable prospects of the economy further testify to Singapore's tremendous strength, accumulated in the course of past decades of vigorous economic development, and the ability of the authorities in economic management, especially in effectively dispatching temporary downtrends in the economy. I am in broad agreement with Mr. Hon's analysis and the staff appraisal of the policy issues.

Singapore, an export-oriented country with a narrow domestic resource base, is very dependent on the development of the external sector and highly vulnerable to external shocks. Although it has been successfully transformed into an economy characterized by high-technology and service-oriented industries with high value-added content, the economy is still in the process of adjustment and recovery from a recent recession as a result of the deterioration in competitiveness and profitability. In such circumstances, it is understandable that the authorities are taking a more cautious and conservative stance regarding the current position and prospective development of the external accounts.

Savings in Singapore, amounting to over 40 percent of GDP, are among the highest in the world. The issue of how to channel this high level of savings into domestic productive activities is interesting and worth further study. In the case of Singapore, such a high rate of savings may be justified in part by long-term demographic considerations and the strong economic recovery of the past two years. However, the rate of savings exceeded that of investment for the past two years and, based on the staff's baseline and alternative medium-term scenarios, this trend is likely to continue for the next five years. The appropriate channeling of excessive savings will apparently have a significant impact on the future development of the economy. The staff suggests that tax reduction is an appropriate policy measure for reducing government savings and, thus, external account surpluses. Looking at the staff's projections, private savings will increase on average by about 1 percentage point annually, while taxes will be reduced and, as a consequence, government savings and external account surpluses will drop. However, it is difficult to see in this scenario the implications of a tax reduction for investment. Is it possible that the tax reduction would give an impetus to investment? I would appreciate staff comments on this point.

Wage restraint and the effective depreciation of the Singapore dollar have been, among other things, major contributors to the recent improvement in Singapore's economic competitiveness. However, the continuing trend of a much lower rate of wage increase than increase in productivity would have side effects for the economy. The authorities have been aware of these problems, and I welcome their recent move toward a more flexible wage system that is more responsive to productivity and profitability. I encourage the authorities to continue their efforts in adjusting the economy and promoting existing competitiveness to achieve sustainable, noninflationary growth in the longer run.

Mr. Rye commented that Singapore's favorable prospects and policies were reflected in the brevity of the staff's appraisal and the close correspondence between the views of the staff and those of the authorities. Singapore was almost a textbook case of a country reaping the benefits of outward-looking economic policies. Of course, those benefits could only accrue to the extent that the open character of the world trading system, on which Singapore heavily relied, was preserved and enhanced.

It was difficult to suggest ways to improve policy, at least in the short and medium term, Mr. Rye observed. He agreed with the staff, however, that over time the budget surplus should be reduced for the reasons suggested by Mr. Enoch, and that tax reductions would be the appropriate means of doing so, thus according Singapore's citizens more discretion in the area of spending. In the longer run, Singapore was likely to face the problems created by a static and aging population. The authorities had begun to take note of that issue in urging employers to raise the retirement age from 55 to 60, which seemed a useful first step. A more voluntary approach might be possible in that connection.

He was confident that the Singapore authorities would continue to demonstrate their ability to rise to the inevitable economic challenges, and that their country would remain an object lesson, if not a source of envy, for policymakers in many other countries, Mr. Rye stated. As there were lessons to be learned from success as well as failure, he was inclined to support for the time being the staff recommendation to leave Singapore on the standard 12-month cycle, although that question could be reassessed in 1989.

Mr. Fogelholm said that he supported those Directors who were in favor of moving Singapore to the bicyclic consultation procedure. That procedure was appropriate because Singapore had demonstrated its ability to handle its economy prudently and did not require Board consideration each year, although the staff report would be made available to Directors on an annual basis.

The staff representative from the Asian Department explained that the staff projections had been based on certain assumptions that could change. The projections merely indicated what would happen if present policies, under assumptions regarding the external environment, persisted. Some of the sensitivity analyses indicated that if those assumptions were modified, the outcome would not change significantly. Nevertheless, the staff had been cautious in interpreting the results of the calculations and for that reason there was no important difference with the authorities regarding the approach that they should take.

In considering Singapore's comfortable external position, the staff had advised the authorities that they might wish to take remedial action, if required, to avoid inflation or a larger than anticipated accumulation of reserves, the staff representative continued. Tax reductions and other measures would have an impact on the balance of payments. Exchange rate policy was also a factor, although the authorities did not rely heavily on the exchange rate to maintain external competitiveness. They considered other measures more effective, notably wages and the relative unit labor cost, which weighed heavily in determining Singapore's competitiveness. The experience of the 1980s demonstrated that fact clearly, when the high wage policy of 1985 had resulted in a significant loss of competitiveness and the trend had been reversed in 1986-87.

The staff did not have more recent data on investment by Japanese multinational corporations in Singapore, the staff representative added. While the realignment among the major currencies had positively influenced the growth of Japanese direct investment in Singapore, other well-known factors had also attracted Japanese investors. While those factors would obviously continue in place, it would be difficult to predict whether investment by Japanese companies would accelerate or taper off.

Given the full employment conditions prevailing in the economy, the staff had not included a recommendation for a tax cut in 1988, the staff representative noted. However, it was necessary to look at the feasibility and efficiency of government expenditure in regard to reducing the surplus. There was little scope for a significant increase in development expenditure, as major development and infrastructural projects had recently been completed. Moreover, given the authorities' desire to reduce the role of Government, particularly in the economy, they would not wish to increase expenditure. Therefore, the most appropriate course of action over the medium term would be to reduce taxes.

The authorities' main assignment for the exchange rate was to maintain low and stable inflation, and their success in exercising that policy was clear, the staff representative from the Asian Department remarked. The Singapore dollar had appreciated significantly during the first half of the 1980s but had depreciated in 1985 and 1986. The rate of depreciation had slowed considerably in 1987, and thus far in 1988 the trend had stopped. The authorities would, without hesitation, further depreciate the currency if developments, such as price pressures, warranted.

The staff representative from the Research Department said that the staff was conscious of the need to be cautious in using econometric relationships in its projections or medium-term scenarios, especially in the case of Singapore, which had undergone structural changes over the past period. The staff had performed some econometric tests of the stability of the savings and investment relationships that were the key to the medium-term scenario results and had found that they did not give evidence of instability, despite, for instance, structural changes under the high wage policy, extending back to 1979, and its later reversal. Although the results should be used with caution, the staff had not perceived changing econometric relationships in the data.

The staff had included the possibility of exporters' profit margins being squeezed in one of the alternative scenarios, reflected in lower savings as the profits declined, the staff representative noted. Perhaps investment might not decrease as indicated in that scenario, but the staff considered that the essential long-term effects would eventually show up as described.

As to whether a worsening of competitiveness could in fact result from a tax increase, the staff had not embodied that fact in its results, the staff representative from the Research Department said. The scenario indicated only the effect of worsening competitiveness on the location of investment of multinationals. Changes in tax rates would be over and above the staff's results.

The Deputy Director of the Exchange and Trade Relations Department commented that the structural surplus and the basic underlying changes that were still working through the Singapore economy, plus the potential for increasing trade friction and the member's importance in the trading system, had persuaded the staff that it would be useful to maintain the 12-month consultation cycle at present. The staff planned to consider with the authorities a move to the bicyclic procedure on the occasion of the next Article IV consultation.

Mr. Fogelholm commented that quite a few countries with much larger economies and in more fragile economic situations had been moved to a bicyclic procedure. Moreover, under the general surveillance of the Fund, the Board could discuss Singapore whenever the need arose--for example, with regard to trade practices--but he did not consider it necessary to keep Singapore on the annual consultation procedure merely because it was successful.

Mr. Templeman stated that he could go along with the staff in following the 12-month cycle at present and reconsidering the procedure at the time of the next Article IV consultation.

Mr Al-Assaf, Mr. Prader, Mr. Fernando, and Mr. Parmena said that they wished to associate themselves with Mr. Fogelholm's remarks.

Mr. Hon thanked Executive Directors for their comments, which he would transmit to his authorities. He believed that they would welcome a bicyclic consultation procedure.

The Executive Directors agreed to place Singapore on the bicyclic consultation procedure.

The Acting Chairman made the following summing up:

Executive Directors commended the authorities for their management of the economy following the recession in 1985, particularly with respect to the improvement in competitiveness and the supportive financial policies, and noted that Singapore returned to vigorous noninflationary growth in 1987-88. Recent policy initiatives included a less restrictive budgetary stance, a relaxation of the restraint on wage increases, and a modest appreciation of the Singapore dollar.

Directors observed that, given the stance of policies the authorities intend to pursue, and assuming the external environment remains unchanged, the outlook for the Singapore economy appears favorable. The economy is expected to grow at its medium-term potential rate of 5-6 percent a year and to become increasingly diversified, inflation is expected to remain low, the external current account to continue in surplus, and official reserves to rise steadily.

Several Directors commented that the projected current account surpluses are large relative to the economy. It was recognized, however, that the surpluses do not arise as a result of trade and payments restrictions--the absence of which was commended by Directors--but reflect high private and government savings stemming from, respectively, the current large proportion of the population that is of working age and the prudent stance of budgetary policies. Other Directors remarked that the projected current account surpluses are modest in a global perspective and that the stance of financial policies was broadly appropriate in the current situation and in light of the prospects for the world economy. It was pointed out that while Singapore currently benefits from a strong world economy, it is not certain that such a favorable environment will continue. A few Directors were of the view that current account surpluses, to the extent that they reflect a surplus in the private sector saving-investment balance, could enable Singapore to increase foreign investment, especially in neighboring countries.

Several Directors pointed out that the projections are subject to uncertainties, and that there is a risk that the surpluses will be larger, with inflationary implications as well as a potential for increasing trade frictions. The desirability of a further increase in reserves was also questioned. To forestall such developments, several Directors suggested that policies might be steered in the direction of yielding smaller surpluses than projected in the baseline medium-term scenario. They agreed that effective policy adjustment would have to come preferably from a reduction in government savings, and in this regard, tax reductions appeared to be an appropriate response.

Directors noted that both wage and exchange rate policy had contributed in the recent past to the restoration of Singapore's competitiveness. Given the present competitive position, further restraint on wage increases would not be warranted, and Directors therefore welcomed the shift toward a system of wage determination that is more responsive to market forces. Some Directors also welcomed the recent conduct of exchange rate policy that had halted the trend of effective depreciation and had allowed some appreciation of the Singapore dollar; they believed that additional real effective appreciation would be desirable.

Directors commended Singapore for its decision to contribute to the enhanced structural adjustment facility.

Directors agreed to place Singapore on the bicyclic consultation procedure. It is expected that the next full Article IV consultation with Singapore will be completed within 24 months.

3. SOLOMON ISLANDS - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Solomon Islands (SM/88/156, 7/22/88). They also had before them a background paper on recent economic developments in Solomon Islands (SM/88/187, 8/19/88).

Mr. Rye made the following statement:

The Solomon Islands authorities are in broad agreement with the staff report, which they consider presents a comprehensive and fair assessment of recent developments and prospects for the economy. As always, the staff mission was most valuable to the authorities in helping them to frame the directions of future economic policy.

In a number of respects, the performance of the Solomon Islands economy over recent years has been disappointing. While unfavorable external developments and the devastation caused by cyclone "Namu" in 1986 are a large part of the story--and underline the vulnerability of small and fragile island economies to such shocks--growth has also been contained by underlying structural rigidities and weaknesses. The authorities recognize that those need to be addressed.

On a more positive note, growth is strong at present (real GDP may rise by 8.5 percent in 1988), the result of substantial investment in new capacity and infrastructure, particularly in fishing, and the successful rehabilitation of productive capacity damaged by the cyclone. Export revenues are forecast to grow strongly, assisted not only by better commodity prices, but also by the authorities' strong commitment to a flexible exchange rate policy. Looking further ahead, the prospects are encouraging for the development of a viable gold mining project. Meanwhile, external debt and debt servicing have been kept to prudent levels.

Nevertheless, the Solomon Islands authorities concur with the staff's judgment that the challenges of demand-management and supply-side constraints will need to be confronted if these favorable developments are to form the basis for a durable improvement in performance over the longer term, and in particular, the resolution of structural weaknesses in the balance of payments.

The authorities recognize the central importance of successfully tackling the poor fiscal performance. The record of repeated overshooting of current expenditure targets is a disappointing one. A phased reduction in the fiscal deficit is, however, planned over the next two to three years. Notwithstanding the forthcoming election, the Government is resolved to make a start now, and the recently agreed 1989 budget is based on an assumption of significantly constrained employment growth and a standstill on cost of living adjustments.

It is understood, however, that sustained fiscal restraint over the longer term will require a considerable strengthening of planning procedures to ensure that the implications of capital expenditures for recurrent costs are fully taken into account, and that expenditure and staffing controls in the public sector are effective. Rationalization and reform of the public enterprise sector are essential if demands on the budget are to be curtailed. The review of public enterprises, to be completed by March 1989 with assistance from the Asian Development Bank, will provide the basis for action by the new Government. On the revenue side, the proposed tax reforms, developed with the help of a Fund technical assistance mission, should help provide the basis for a more comprehensive and reliable tax structure and a clamp-down on tax avoidance.

Greater success on the fiscal front would help considerably to ease the current burden on monetary and exchange rate policy. The options available to the monetary authorities in a small open economy with a poorly developed financial market are, of course, limited. The authorities recognize, however, that monetary conditions must be further tightened if the current pressure on domestic prices and external reserves is to be resisted. A 5 percent statutory reserve deposit for banks has been reintroduced by the Central Bank, and the ceiling on time deposit interest rates has been removed. While ceilings on lending rates and interest subsidy arrangements for locally owned businesses remain in place, these schemes are designed to provide specific but limited assistance to particular target groups, within the overall tightening of financial conditions. The authorities intend to administer the controls flexibly, in line with their approach to the exchange rate, to ensure that lending costs stay in touch with market forces.

The task of preserving the Solomon Islands' external reserves has to date fallen largely to exchange rate policy, which has been flexibly administered to offset domestic price trends. This approach will continue. The authorities acknowledge, however, the risk of getting caught on an inflationary treadmill, as the gains from depreciation to real competitiveness are eroded. This further underlines the importance of a tight monetary policy and, over the medium term, an improved fiscal performance.

As the staff has noted, gains in competitiveness need also to be backed by a medium-term program of structural reform, aimed at removing supply constraints and improving incentives for private investment. The authorities recognize that the successful resolution of these constraints needs to be addressed in the context of a medium-term program of administrative reform and public sector rationalization, and a significant realignment of the current macroeconomic policy burden. The planning for such a program has just begun, with the aim of providing the basis for decisions on all these fronts following the forthcoming election.

Given favorable external conditions, the Solomon Islands economy has the clear potential to benefit as a small but efficient producer of primary commodities. My authorities are optimistic that recent policy failures can be reversed, and the necessary foundation laid, to turn this potential into reality. In this regard they are grateful for the continuing support and encouragement of the Fund.

Mr. Heywood made the following statement:

In recent years Solomon Islands has been buffeted by a succession of exogenous factors which have made sustained economic progress particularly difficult to achieve, despite the country's abundant supply of natural resources. The openness of the Solomon Islands economy makes it extremely vulnerable to adverse shifts in the terms of trade. In addition, the authorities have had to cope with the major cyclone of 1986 and a decline in ocean temperatures. These factors highlight the point that, despite the welcome improvement in the statistics on the national income accounts, the projections in the paper should be treated with greater than usual caution, in particular with respect to the medium-term outlook. The improved statistics on the national accounts should aid substantially in medium-term macroeconomic planning.

The vulnerability of the economy to external shocks underlines the need for the authorities to keep a firm grip on domestic demand-management policies, and to pursue with vigor structural policies designed to improve the economic infrastructure, to strengthen the fiscal position, and to enhance the performance of the export sector.

Unfortunately, as Mr. Rye points out, there have been worrying developments on both the fiscal and monetary sides over the last year. While the worsening budget deficit could partly be explained by the increase in much needed capital expenditure that was financed by foreign assistance, there was also a significant increase in current spending, which has continued strongly into 1988. The failure to adhere to the 1988 budget plan has been mainly the result of an unexpectedly large increase in the wage bill--comprising both an increase in wage levels and in civil service employment--which does not appear to have been offset by improved income tax receipts to any significant extent.

I agree with the staff that the authorities should strongly oppose any further wage increases. A ratcheting up of the general wage inflation rate would be particularly unwelcome at this juncture. I also hope that the authorities will be able to take early steps--drawing, as necessary, on external technical assistance--to implement the structural measures identified by the recent series of policy reviews. As Mr. Rye notes, the strengthening of the expenditure control system would seem to be particularly important, together with further progress toward implementation of the tax reform proposals drawn up last year. I was also encouraged to note that the authorities are reviewing the scope for privatizing, or at least commercializing, parts of the public enterprise sector, which should make a useful contribution to the fiscal position over the medium term.

The authorities have acknowledged that, notwithstanding the volatility of money demand, a tightening of monetary policy is warranted, particularly given the recent upturn in inflation. While an improvement in the fiscal position would clearly be helpful in this context, in my view, there is something to be said for removing the interest rate ceilings which have just been introduced. I am not sure what purpose these ceilings are intended to serve, particularly if they are expected to be held close to market levels. There would certainly seem to be little case for having both general ceilings and specific subsidies if the aim is to increase the flow of credit to small businesses. Moreover, as the staff points out, there are dangers in allowing deposit rates to become negative in real terms, regardless of whether the interest is taxable or not.

The need for tighter monetary and fiscal policies is amply demonstrated by the staff's medium-term projections for the external position, which assume a fairly steady current account performance, combined with a prospective decline in official foreign assistance compared with the flows received in 1987 and 1988. Even accepting the uncertainties inherent in these medium-term projections, it seems that, on the basis of current policies, large external financing gaps are likely to emerge from 1990 onward.

With respect to structural reform, the authorities have clearly put a good deal of preparatory work into the formulation of policies to improve the economy's supply performance. In view of the prospective external financing gap, measures designed to improve and diversify the export base and to encourage direct foreign investment would seem to be particularly important. The proposals designed to establish a framework for registering land rights are especially welcome, given the difficulties inherent in this issue. It should be relatively straightforward for the authorities to begin simplifying the approval procedures for foreign investment. Given the range of structural policies under consideration, it will of course be important for the authorities to establish priorities, to ensure that the administration does not become overburdened.

In recent years, the authorities have had to battle a series of adverse exogenous developments which have sharply reduced real per capita incomes. The economy of Solomon Islands is now set for a strong and welcome growth rebound, and, provided the authorities can put in place the appropriate macroeconomic framework, the structural measures they have identified should help the economy to realize its considerable growth potential over the coming years.

Mr. Yoshikuni stated that he was in broad agreement with the staff's appraisal. Some of the economic developments in Solomon Islands in 1987 had been worrisome. While some could be attributed to the lingering effects of the ruinous economic environment of the previous year, deep-rooted structural weaknesses had also played a role. The reform of the public enterprises was important, in order to address those problems. While recognizing the large role that the public sector played in the economy of Solomon Islands, he noted that the profitability of the public enterprises had deteriorated sharply over the last few years, and the deficit of the public enterprises was not an insignificant burden on the public sector budget. The enhancement of private sector activity was needed over the medium term, and an improvement in financial intermediation and foreign investment authorization procedures was necessary toward that end. Other structural weaknesses needed to be dealt with immediately, among which were supply-side bottlenecks. The weakness of the infrastructure--especially that of the transportation system--and land tenure problems were also some of the major issues that needed to be addressed vigorously. The fact that the necessary reforms would be time consuming to implement and would require large financial resources was acknowledged. The steady and effective implementation of the program of structural reform would require a sound macroeconomic framework.

Viewed in that light, economic developments in 1987 had not been satisfactory, Mr. Yoshikuni went on. On the fiscal front, the large wage increase was a matter of concern. He welcomed the authorities' intention to take offsetting measures against additional wage awards for the current year. In view of the weak budget position, however, wage developments would need to be monitored closely over the coming years. Implementation of the investment program in consideration of priorities and the overall review of expenditures was also essential. On the revenue side, given the technical difficulties of tax administration in Solomon Islands, he wondered whether a broad-based indirect tax system, such as a consumption tax, was not more suitable. The authorities should make efforts to eliminate the current budget deficit in the next fiscal year.

The authorities' flexible exchange rate policy was welcome, Mr. Yoshikuni noted. Because of the extreme openness of the economy, and its reliance upon a few primary commodities, a flexible exchange rate management policy should continue to be the main tool against volatile export commodity price movements, thus ensuring the profitability of the export sector. He urged the Solomon Islands authorities to keep the exchange rate under close review. The export sector was still narrowly based, despite the authorities' efforts, and further diversification of exports was necessary. He would appreciate more information from the staff about recent export diversification developments, especially in the tourism sector.

As the staff paper had pointed out, Mr. Yoshikuni concluded, the flows of external concessional finance were expected to decline substantially from 1990, and the economy could be seen to be standing at the crossroads. Under those circumstances, he believed that it would be desirable to review economic developments in Solomon Islands and provide some policy recommendations after one year, rather than two years. Consequently, his chair preferred keeping Solomon Islands on the standard 12-month consultation cycle.

Mr. Warner made the following statement:

> We welcome the fact that, according to Mr. Rye, the authorities of Solomon Islands are in broad agreement with the staff report. However, it is unfortunate, particularly given the

fragility of the economy, that they have not yet begun to implement the adjustment measures recommended in the report.

The level of real economic growth projected for 1988 is the result of several factors mentioned in the staff report and by Mr. Rye, most notably the flexible exchange rate policy. In our view, this level of growth should provide the authorities with additional scope to take some of the needed adjustment measures that will provide for a sustainable balance of payments over the longer term.

Clearly, additional fiscal adjustment will be critical, and we welcome the authorities' stated resolve to start tackling this problem before the election. Their ability to hold firm on their commitment to contain public employment and refrain from awarding cost of living adjustments will be important elements of this effort. It is also encouraging that the authorities have undertaken a number of policy reviews, covering most aspects of public expenditure. Urgent implementation of the measures recommended in these studies, which will help to improve the fiscal situation, is called for.

Looking toward the medium term, however, it is troubling that the authorities have not yet fully specified concrete measures to achieve the targeted elimination of non-STABEX domestic financing. It appears, however, that the growth of domestic liquidity may not even be adequately contained if non-STABEX domestic financing were curtailed to the extent envisaged. We urge the authorities to find additional ways to generate public savings, including through the improvement of the financial position of the public sector enterprises, in line with the technical assistance study of the Asian Development Bank.

We note that the authorities recognize that monetary conditions must be tightened further in order to avoid pressures on prices and the flexible exchange rate policy. We are concerned, however, about the introduction of interest rate ceilings, even though the authorities intend to administer those ceilings flexibly. We also stress the importance of maintaining positive real interest rates to generate savings, particularly in light of the fiscal situation.

We noted a number of important areas where structural reform is needed, including land tenure and transportation. We urge the authorities to move quickly and decisively to address these problems, since their resolution--which will undoubtedly take time--will provide a more lasting base for improvements in the economy.

We wondered why the staff's medium-term scenario was prepared only on the basis of the present policy stance. It might have been useful for the authorities to see the outcome of a changed set of policies, along the lines proposed by the staff.

We are encouraged by the authorities' flexible management of the exchange rate and the resultant increase in exports, which has fueled the economy's recent growth. We hope that the authorities will be able to maintain this policy in spite of public concerns about price pressures, so that Solomon Islands' competitiveness can be maintained.

We support the use of the bicyclic consultation procedure in this case, but hope that the authorities will seriously consider adopting a strong adjustment program.

The staff representative from the Asian Department stated that the purpose of implementing interest rate ceilings if they were held close to market levels was not entirely clear. In his view, there was a danger in having such ceilings even with the intention of administering them flexibly, because they invited political pressures to hold them down. For that reason, the staff had recommended that they be eliminated.

The country's export base was certainly very narrow, the staff representative went on. Solomon Islands depended upon two major commodities, fish and timber, which together accounted for approximately two thirds of export earnings. There had been some modest success in encouraging diversification into nontraditional exports, the most successful of which had been into cocoa. Export volumes of cocoa had tripled over the previous five years. Considerable potential for other natural-resource-based exports also existed, among which were spices and gold mining. The potential for touristic development was large, but remained generally unexploited. The significant increase in tourist arrivals that had been experienced in 1987 could be attributed to disturbances elsewhere in the region, and was probably only temporary. The authorities intended to promote gradual and orderly development of tourism, because they were concerned about the potential undesirable effects of unrestrained tourism on the local society. Their focus with respect to tourism development was on improving the transportation links, particularly through an expansion of the airport facilities.

The staff had indicated briefly in the report the possible outcome of an alternative balance of payments scenario, the staff representative noted. The staff had indicated the order of magnitude of adjustment of the external current account that it felt would be necessary in order to close the financing gap--on the order of 5 percent of GDP--most of which would have to be generated by public sector savings. That showed the magnitude of fiscal adjustment that would be required for a sustainable balance of payments.

He agreed that, depending upon the outturn of the balance of payments and the success of the domestic policies, either the Board or the authorities themselves might wish to request another consultation in 12 months' time, the staff representative stated. The bicyclic consultation procedure provided for such a possibility, and, if the Board so desired, Solomon Islands could be placed on the agenda at the time of the interim consultation.

Mr. Rye commented that the new interest rate ceilings needed to be seen in the context of the monetary sector in Solomon Islands. The monetary and banking sector was not a robustly competitive market, so that some guidance from the central banking authorities might be appropriate. His Solomon Islands authorities had no objection to being placed on the bicyclic consultation schedule, but they would certainly wish to have discussions with the staff by mid-1989. A new Government would take office in Solomon Islands in March 1989.

Mr. Yoshikuni remarked that as long as there would be close contact between the authorities and the staff, he would not hold to his position about keeping Solomon Islands on the standard 12-month consultation schedule.

The Acting Chairman concluded that the Executive Directors had approved placing Solomon Islands on the bicyclic consultation schedule, while recognizing that the same high degree of staff involvement would continue, especially in view of the contributions the annual consultations had made to the Government's decision making.

The Acting Chairman then made the following summing up:

> Directors were in broad agreement with the thrust of the staff appraisal. They noted that a difficult environment, including low export prices and a destructive cyclone in 1986, had adversely affected the economy and contributed to slow growth. Exceptionally large inflows of foreign aid had provided temporary relief to the balance of payments and allowed a rapid expansion in government expenditure, but it was noted that the level of foreign aid was likely to diminish over the next few years. A strong adjustment effort, emphasizing both budget and monetary policy and structurally oriented policies, was thus urgently needed to achieve sustained growth with external viability.
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> Directors emphasized the need for an early, substantial reduction of the budget deficit. Such a reduction would have to be achieved mainly through a firm rein on expenditures, although there was also scope for increasing the efficiency and broadening the base of the tax system. Directors expressed concern about the recent escalation of some public sector salaries, and recommended that the growth of public employment be held down. They noted that transfers to public enterprises had become a

significant drain on the budget, and urged the authorities to reduce such budgetary support. They also urged the authorities to consider the privatization of certain enterprises, where feasible, along the lines of the study completed with the Asian Development Bank.

Directors viewed the recent acceleration of inflation and the underlying weakness of the external position as clear indications that monetary conditions needed to be tightened. They expressed concern over the likely adverse effects of the recently introduced ceilings on interest rates, and stressed the importance of maintaining positive real rates to promote domestic savings.

The authorities' flexible management of the exchange rate in recent years had been a factor in preventing a more serious deterioration in the external position and in mitigating the effect on export profitability of low commodity prices, Directors noted. They encouraged the authorities to continue with flexible exchange rate management, to help ensure adequate expansion of the export sector, and to promote diversification over the medium term.

Directors observed that a number of structural problems represented serious constraints on growth, among the most prominent of which were unresolved land tenure issues and impediments to foreign investment. They hoped that the authorities would address those issues as part of a comprehensive medium-term adjustment program with clearly established structural adjustment priorities that would take account of administrative constraints.

Directors agreed to place Solomon Islands on the bicyclic consultation schedule. It is expected, accordingly, that the next full Article IV consultation with Solomon Islands will take place in 24 months.

4. GABON - 1988 ARTICLE IV CONSULTATION, AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1988 Article IV consultation with Gabon, and the third review under the 25-month stand-by arrangement for Gabon approved on December 22, 1986 (EBS/88/168, 8/17/88; and Cor. 1, 9/14/88; and Cor. 2, 9/16/88). They also had before them a background paper on recent economic developments in Gabon (SM/88/205, 8/31/88; and Cor. 1, 9/6/88).

Mr. Mawakani made the following statement:

At the second review of the current stand-by arrangement last February, the Executive Board had the opportunity to assess the progress made by the Gabonese authorities in the difficult but necessary task of adjustment undertaken since the collapse of oil prices in 1986. The Board noted the broadly satisfactory progress that had been made, and encouraged the authorities to pursue their efforts, in order to return the economy onto a sustainable growth path over the medium term. Despite the difficulties the authorities have encountered, their commitment to the adjustment process remains firm.

Like other oil exporting countries, Gabon experienced a considerable setback in economic and financial performance when oil prices declined sharply in 1986. On the basis of the most recent data provided by the staff, it is estimated that GDP declined by 17 percent in real terms in 1987. Domestic demand is estimated to have declined by about 22 percent, reflecting a fall in consumption, and a sharp cut in capital formation, leading to significant economic deflation. Consequently, inflation has been subdued, and the consumer price index has shown substantial improvement. However, performance in the fiscal sector was mixed: due to an unexpected revenue shortfall both in the oil and non-oil sectors, and to some expenditure overruns, the overall budgetary deficit (on a payment order basis), at 11.1 percent of GDP, was somewhat higher than programmed--8.5 percent of GDP--but this was an improvement over 1986 (14.9 percent of GDP). The deficit on the external current account improved significantly in 1987, from 32.1 percent of GDP in 1986 to 14.3 percent of GDP in 1987, due mainly to large cuts in oil sector purchases of services, reflecting reduced investment outlays.

The economic situation in Gabon remains difficult in 1988 because of the less favorable prospects for oil prices. Real GDP is expected to decline further, reflecting the slowdown in nonoil sector activity. However, inflation will continue to be low, and on the fiscal side, further improvement is expected to be reflected in a reduction of the budgetary deficit. Reduction of external imbalances is also expected.

The main thrust of the adjustment process in Gabon for the current stand-by arrangement is on the fiscal side, as the budget is considered to be a major element in restoring the strength of the country's financial situation. As indicated in the letter of intent, the achievement of the initial budgetary target set for 1988 was compromised by unfavorable developments in 1987. As a result, a new target was set during the second review of the program. In order to strengthen the adjustment process, the authorities introduced far-reaching fiscal measures during the second half of 1988.

On the revenue side, these measures include, among others, the tightening of procedures for granting ad hoc customs exemptions and their monitoring, the increase in the rate of turnover tax for the breweries (from 10 to 15 percent), and the imposition of a minimum levy on certain consumer goods. On the expenditure side, most of the measures are related to a better and tighter control of current expenditures on goods and services. Further action has also been taken to contain the wage bill through the implementation of measures arising from the recently completed census of the civil service. These include the retirement and layoff of many civil servants. As a result of these measures, it is now expected that the 1988 budget deficit (on a payment order basis) will represent 8.3 percent of GDP, compared with 14.9 percent in 1986.

On the wage bill, it should be stressed that since the start of the adjustment program, the curtailment of salaries through various measures has reduced the purchasing power of civil servants in general by as much as 14 percent in nominal terms. The social and political impact of such a loss of income should not be underestimated.

In the monetary sector, performance under the program has remained broadly in line with the objectives. The authorities are concerned at the continued delays in the disbursement of structural adjustment loans from the World Bank and the African Development Bank, which could complicate the implementation of monetary policy for the rest of the year.

The vulnerability of the Gabonese economy to exogenous shocks and the poor prospects for achieving durable economic growth and a viable balance of payments position over the medium term prompted the authorities to accelerate the implementation of structural reforms, with the aim of bolstering the productive capacity of the country's non-oil sector. To this end, a structural adjustment program, with the financial assistance of the World Bank and the African Development Bank, is being implemented. Under this program, the reform of the parastatal sector is under way. Audits have already been conducted on most of the public enterprises, and actions have been taken to liquidate seven of them; 2 have been privatized, and 11 are being restructured. Further actions are expected in the near future. In the meantime, in order to improve the competitiveness of the economy and to reduce the cost structure, an ordinance prescribing the procedures for determining salaries in the parastatal sector was issued in April 1988 and is being applied. As indicated in the letter of intent, its application will result in the harmonization of the salary structures and the establishment of coherent organizational structures, as well as a 12 percent reduction in average monthly remuneration in the public enterprises.

Notwithstanding the progress achieved under the current stand-by arrangement, it is my authorities' view that a global strategy that could ensure the real diversification of the economy over the medium term should be developed. In this context, they believe that a facility like the revitalized external Fund facility would be more appropriate. They therefore look forward to the forthcoming discussions with the Fund on the elements of a program that could be supported by such an arrangement.

Mr. Serre stated that, as the staff report had highlighted, the Gabonese economy stood at the crossroads of the adjustment path. During the second review of the program supported by the stand-by arrangement, the Gabonese authorities had been encouraged to implement the necessary measures immediately, in view of the past performance of the economy. He noted with concern that the authorities' difficulties had progressively worsened, because the prescribed measures had not been implemented fully, and because of inadequate controls on expenditures.

External current account viability was to be attained by 1992 under the medium-term scenario, Mr. Serre observed, with monetary and budgetary policy and structural reform to be the principal tools toward that end. With respect to the revised budget figures for 1988, he called attention to the difference between the deficit expressed as a percentage of GDP in the revised and in the initial budget program, and urged the Gabonese authorities to implement the appropriate measures in order to restrain current outlays accordingly. The need to share the burden of adjustment required a stringent public sector wage reduction, including expatriate salaries. He welcomed the authorities' decision to contain the wage bill in 1989; his chair would watch closely for the implementation of that decision. The exclusion of nonimmediate productive investments from the 1989 budget formulations would also be advisable. Given the sensitivity of the Gabonese economy to the international oil market, and the ease with which policy slippages occurred, he was pleased that the authorities had implemented revenue measures, although he was unsure that they could be implemented in the way that was being planned, particularly in the customs and informal sector areas. Consequently, he urged the authorities to strive to avoid other slippages in those areas.

The restructuring of the parastatal enterprises should be achieved as quickly as possible, Mr. Serre observed, but, as the Gabonese authorities had rightly stressed, an in-depth review of the sector would first be necessary. The authorities needed to ensure that unfavorable and unexpected side effects of the reorganization on the rural economy were avoided.

He regretted that the criterion on net bank credit to the Government had been overshot, Mr. Serre remarked. The overshooting could be attributed to delays in implementing corrective actions. However, the decisions with respect to interest rates and bank liabilities represented a more satisfactory performance by the authorities. Significant progress with respect to domestic credit policy would be essential in the near future. On the external side, it appeared that the current account deficit would remain substantial at the end of the program period, and that external financing would thus continue to be necessary. He believed that multilateral and bilateral donors would make disbursements rapidly once the willingness of the Gabonese authorities to implement the program became clear; however, he concurred with the staff's conclusion that financing imbalances on the scale that had existed in the past would not be feasible.

The Gabonese authorities should see their current predicament as an opportunity to take the needed structural measures, even if those measures had serious social ramifications, Mr. Serre concluded. Since he believed in the authorities' willingness to implement the program, he could support the proposed decision.

Mr. Prader stated that his chair supported and recognized the efforts and achievements of the Gabonese authorities. He was in broad agreement with the staff report.

Gabon's economy resembled in some respects that of other oil producing nations in the early 1980s, Mr. Prader observed, as Gabon had been a latecomer to the adjustment process. Delayed adjustment to declining oil prices had been reflected in the alarming increase in the ratio of debt to GDP.

He welcomed the authorities' efforts to broaden the tax base and include the informal sector in it, to make the import tax system more effective and to increase import tax receipts, Mr. Prader remarked. However, as tax evasion and leakages appeared to be the most serious shortcomings in the current tax system, the authorities might usefully consider the implementation of a general value-added tax--which had been successfully introduced in many developing countries--to replace the current turnover and transaction taxes. The major benefit of a value-added tax system was the establishment of better reporting practices which it necessitated.

He supported the 1988 financial program, Mr. Prader went on. The program's chief features were a freeze on promotions and an elimination of multiple salaries in the public sector, and a reduction in the number of government employees. He welcomed the current restructuring of the parastatal companies--another problematical area of government expenditures--and urged the authorities to develop economic criteria to determine the efficiency and rationality of those companies. Such criteria had been identified in other developing countries, most notably in India, for example.

The measures that had been undertaken in the current adjustment program had been adequate, Mr. Prader commented, and had brought with them both some relief and discipline to the Gabonese economy. He recognized in particular the authorities' willingness to correct, through the introduction of additional measures, the major slippages that had occurred in the monetary and fiscal fields. Nevertheless, sustainable growth and a viable balance of payments position in the medium term would require action in the direction of diversifying and enhancing the export base.

Mr. Kabbaj made the following statement:

Gabon's economic and financial situation has deteriorated in the wake of the sharp and continued decline in international oil prices, like that of many developing oil exporting countries. Gabon's problems have been further compounded by the sharp appreciation of the CFA franc, as the monetary zone arrangements place the greatest burden of adjustment on budgetary policies, with well-known political and social consequences.

The case of Gabon also illustrates the fact that it is impossible for developing countries to make significant progress in their courageous adjustment efforts when they are confronted with overwhelming exogenous factors. Before such unfortunate problems developed, Gabon had almost none--except for a short period at the end of the 1970s, when the authorities' decisive action allowed the country to regain its creditworthiness.

Growth has been negative for three consecutive years. Exports and imports fell sharply, while the terms of trade deteriorated by more than 60 percent in 1985 and 1986. Government revenues, which are heavily dependent on oil exports, decreased by 77 percent in 1987, after a decrease of 29 percent in 1986. Current and capital expenditures were sharply curtailed. Faced with such a difficult situation, the authorities have intensified their adjustment efforts--for which they should be commended--despite the slippage which occurred at the end of 1987. Indeed, the adjustment in the overall deficit of the central government was of the order of 4 percentage points of GDP--a sizable adjustment under the circumstances, even if it was less than the improvement contemplated in the program, which, at 6.4 percentage points, was, in my view, unrealistic. The adjustment on the external front was more pronounced, as the current account deficit was more than halved, and exceeded the program target by 5 percentage points.

This mixed picture is due largely to exogenous factors and is not the result only of policy slippage, as the staff implies. It is sometimes difficult to proceed with all programmed measures, especially when social or political problems which could reverse the thrust of the adjustment effort are identified. In that case, some delays are not unwarranted. Consequently, the decision to revive the stand-by arrangement with Gabon and approve the revisions introduced into it to make it compatible with recent developments is appropriate. This is indeed what is to be expected from reviews, which should not be confined to monitoring the observance of the performance criteria.

Attainment of the targets and performance criteria agreed upon for 1988 will put Gabon on a better footing to face the difficult year ahead. The commitment of the authorities to further adjustment and structural reforms, as Mr. Mawakani stated, is essential to the success of the present program, as well as to the success of the next one. Given Gabon's deep-seated problems, I share the authorities' view that a facility such as the revitalized extended Fund facility would be more appropriate. I support the proposed decision.

Mr. Parmena made the following statement:

I welcome the timely revenue and expenditure measures taken by the Gabonese authorities in the course of the year to put the program back on track. The nonobservance of the performance criteria for end-December 1987, and the problems encountered in the early part of 1988, were due primarily to factors beyond the authorities' control, namely, delays in loan disbursements, the fall in oil revenues in 1988, and the depreciation of the U.S. dollar, which led to lower royalty payments and revenue shortfalls. Nevertheless, expenditure overruns and the failure to contain expenditure levels to those stipulated under the program, especially in the civil service and some other current expenditures, also accounted for the slippage. It is important to note, however, that the Government has acted decisively to implement firm measures to boost revenue and exercise tight control. I was particularly encouraged to note that some of the measures will have a long-term positive impact on tax elasticity--in particular, measures that broaden and deepen the coverage of import taxes and improve their administration and collection, and the increase--from 10 to 15 percent--in the rate of turnover tax for the breweries.

A more striking observation on the Gabonese adjustment effort is the feasibility of attaining medium-term balance of payments viability. The sharp adjustment to reduced oil prices, which is still considered to be a worrisome factor in the medium term, makes the attainment of medium-term external viability elusive. Progress in adjustment to date has entailed substantial cuts in imports and investment, and the 1988 investment budget includes no new projects. The continuation of such a retrenchment of capital formation is likely to cause the contraction of non-oil GDP to intensify in the medium term. Thus, while the Fund has stressed the need for adjustment with growth, what is happening in Gabon is the opposite of growth-oriented adjustment, and is therefore unlikely to lead to medium-term viability.

For medium-term viability to be attained, the structural adjustment that is now proceeding with the assistance of the African Development Bank and the World Bank must succeed. Structural adjustment and parastatatal reform hold the key, since the parastatal sector constitutes a large part of the economy's productive capacity. Also, the civil service wage bill now accounts for more than 10 percent of GDP. Structural reform of the production and public sectors is critical to Gabon's long-term external viability as well. I welcome the close collaboration of the staff of the Fund and the World Bank in the reform of these sectors. I fully agree with Mr. Mawakani that, with respect to a new program in 1989, the revitalized extended Fund facility would be more appropriate than another stand-by arrangement.

We were pleased to note that it is expected that the current account deficit will be reduced in 1988 despite a 14 percent decline in oil exports. The overall deficit will remain large, but both official and private creditors have granted favorable rescheduling terms for 1988. However, while such rescheduling removes the balance of payments pressure for 1988, and improves the debt service ratio from 30.6 percent to only 8.7 percent, in the medium term it can be observed that the ratios become worse after rescheduling than they would have been in the absence of rescheduling. Furthermore, the stock of external public debt rises sharply from 59 percent of GDP in 1987, to 74 percent in 1989. This shows clearly that the Gabonese economy will be faced with a debt overhang in the medium term, which will exert a depressing effect on growth, and which is another indication of the effect of the postponement of problems into the medium term. We hope that the staff, the authorities, and creditors will continue to look for solutions. We support the proposed decision.

Mr. Malhotra stated that he was in general agreement with the staff appraisal. Gabon's good performance in reducing both macroeconomic imbalances and structural constraints to growth had evidently allowed the authorities little room for maneuver; the nature of Gabon's economic problems required ambitious targets. Gabon's vulnerability to external events meant that the achievement of targets, and the concurrent implementation of structural policy measures, could only be secured if an external environment compatible with those targets could be assured. The extended Fund facility might be a more efficient instrument to support Gabon's adjustment efforts, as it could accommodate better the time scale of the adjustment actions that would be needed. However, the authorities needed to demonstrate their commitment to adjustment more convincingly, and he noted that Mr. Mawakani had assured the Board that the authorities were indeed ready and willing to undertake and sustain the required actions. He hoped that adequate margins would be included in the design of such an adjustment program, so that unexpected and unavoidable deviations could be taken into account. He supported the proposed decision.

Mr. Othman made the following statement:

> In 1987, Gabon made some progress in adjusting to the severe financial imbalances brought about by the sharp decline in oil prices in 1986, the effects of which were significantly compounded by the depreciation of the U.S. dollar in local currency terms. This progress was obtained in response to a series of measures taken by the authorities in the context of an adjustment program which aimed at attenuating the immediate financial imbalances, while designing structurally oriented measures to diversify the productive base of the economy. The economic outturn in 1987 was thus in conformity with program targets in the areas of output, the external current account, and monetary aggregates. Also, price performance improved significantly. However, performance in the fiscal area, notwithstanding the progress made toward adjustment, was inadequate.
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> The slippage in the 1987 budgetary outturn and less favorable prospects for oil prices have rendered the achievement of the 1988 program targets, as well as the restoration of balance of payments viability by 1991-92, more difficult. Against this backdrop, and given the key role of improved budgetary performance in Gabon's overall adjustment effort, a strengthening of the fiscal effort was clearly needed. We therefore welcome the introduction by the authorities of urgent fiscal measures, with the aim of reversing most of the earlier slippages. The authorities' action in this regard clearly demonstrates their resolve to take difficult corrective steps in order to preserve the country's financial future. Some of the measures undertaken, notably those aimed at containing the wage bill, are indeed of particular social and political sensitivity. Their implementation, therefore, reflects the recognition that public sector wage restraint is one of the key elements of the program, not only because of the immediate macroeconomic implication of that restraint, but also because of its implications for Gabon's international competitiveness, particularly since the country's exchange rate is a product of its membership in a monetary union. In all, the measures undertaken should strengthen the momentum of the adjustment process in the second half of 1988 and beyond.
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> We welcome the authorities' acceleration of the implementation of structural reforms, with the aim of enhancing the

country's productive capacity in the non-oil sectors. Although the problems encountered in the reform of parastatals, which is a key element of the structural adjustment program supported by the World Bank and the African Development Bank, turned out to be greater than initially envisaged, significant progress has been achieved. Of the 38 most important enterprises, 7 have already been liquidated, or are about to be, 2 have been privatized, and 11 are being restructured. The authorities' intention to undertake further action in the area of structural reform in the near future is welcome.

Gabon's economic prospects over the medium term are highly dependent on developments in the international oil market, as well as on exchange rate developments. In this regard, we note the downward revisions in both the oil price and exchange rate assumptions, and share the staff's concern about the implications of lower oil prices and a higher exchange rate for the economic outturn in 1989 and beyond.

The authorities should persevere in their adjustment effort, and we consider that the adjustment measures that the authorities have undertaken recently demonstrate that their commitment to the adjustment process, despite the difficulties encountered, remains firm. We hope that the forthcoming discussions between the authorities and the Fund on a new program will be successful. We support the proposed decision.

Mr. Al-Assaf made the following statement:

Gabon was faced with a serious adjustment challenge in the aftermath of the decline in oil prices in 1986, like most oil-dominated economies. The authorities responded appropriately by adopting a Fund-supported adjustment program. Initially, they undertook encouraging policies, leading to a significant reduction in the current account and budget deficits, through marked reduction in imports and restraint on government capital outlays.

The adjustment to more normal levels of export revenues can take place more appropriately by reducing economic activity to a sustainable level, which can best be attained by shifting from a severe contraction of capital outlays to a more balanced expenditure reduction. Capital expenditures on high-quality investment should be maintained, albeit in smaller amounts. At the same time, more courageous cuts in current expenditures should be effected. A more efficient and robust economy, with a sustainable growth potential, will thus gradually emerge.

It is regrettable that the authorities were unable to implement fully the designed program, especially with respect to expenditure containment. As a result, the unfavorable economic situation has been aggravated, while adjustment has been made more costly. However, it is encouraging to note that the authorities have recently introduced expenditure and revenue measures that will offset some of the slippages which occurred at the beginning of 1988. Nonetheless, the authorities will need to maintain tight control of current expenditure, and scrutinize capital outlays closely.

The authorities will need to press forward with the reform of the civil service, and should exert every effort to contain the wage bill. The latter is especially important owing to its substantial effect on export competitiveness, given Gabon's membership in a monetary union. What is more important, the public sector enterprises, which were instituted during an era of above-average export receipts, need to be rationalized. In this regard, I welcome the authorities' collaboration with the World Bank, and I urge them to set promptly a detailed timetable to implement the envisaged parastatal reform.

The medium-term outlook for Gabon is not encouraging, since Gabon continues to be dependent on oil as its main export. The authorities will therefore need to pay special attention to diversifying the economy's productive base. Moreover, the authorities have been accumulating foreign obligations, the total amount of which is increasing at a substantial and unsustainable rate. Hence, it is important that the development strategy be reoriented from excessive reliance on foreign financing to greater reliance on domestic savings.

Although the authorities began to address their difficulties in the appropriate way, they relaxed their efforts soon after. Gabon cannot afford further policy implementation slippages, nor lax financial measures. This chair realizes the significant cost of the needed adjustment, but it also recognizes the immense cost of delaying such adjustment. With respect to Mr. Prader's point that the Gabonese experience of delayed adjustment to lower oil prices in the early 1980s is shared by other oil exporting countries, I would note that my own country, Saudi Arabia, responded immediately to those price changes. It is evident from Mr. Mawakani's statement that the authorities are interested in a more comprehensive medium-term adjustment strategy based on a new arrangement with the Fund. I urge the authorities to persevere in their efforts, so that the full implementation of the remaining measures will lead to further collaboration between the Fund and Gabon. I support the proposed decision.

Mr. Goos commented that the staff paper made rather sobering reading, especially if it were compared with the report on the previous review in

February 1988, which had offered a generally satisfactory picture of Gabon's overall performance. He did not wish to detract from the adjustment efforts and achievements of the authorities, and he acknowledged the very difficult environment in which the authorities were operating, but the slippages which had occurred, and which had contributed in large measure to the deterioration of the situation, were a matter for serious concern.

He welcomed the additional adjustment measures that the authorities had adopted recently, Mr. Goos went on. It was, however, less gratifying to note that those measures were not likely to correct the program deviations that had occurred so far. In view of the size of the deviations, however, such a reversal probably would not have been possible in any case. Nevertheless, the prospects that the original targets would not be maintained undoubtedly underscored the staff's warning that there was no further margin for slippages, and that the effective implementation and monitoring of adjustment measures was of paramount importance to the success of the program for 1988.

With respect to the staff's proposal to modify several performance criteria and indicative targets in order to allow a full disbursement under the stand-by arrangement, subject to the observance of the September performance criteria, Mr. Goos continued, the procedure that had been proposed was rather problematical, especially in the case of Gabon. It seemed to imply that repeated program deviations of a substantial magnitude, and largely of the authorities' own making, would be remedied by a considerable softening of the performance criteria in the original adjustment targets. He wondered whether those deviations justified making available the full amount of Fund financing that had been envisaged under the arrangement. That issue warranted a careful evaluation, in his view, especially from the perspective of whether full disbursement would be consistent with the need to assure that the mix of adjustment and Fund financing was appropriate.

Against those concerns, Mr. Goos concluded, he agreed that the authorities' clear demonstration of commitment to adjustment, and their ability to implement adjustment, would be critical to any decision on a possible request for an arrangement succeeding the current one. Those considerations would assume additional importance in the case of an arrangement under the extended Fund facility, in which the effectiveness of structural reform measures would be based on a strong implementation and monitoring capability. The approval of a further request would undoubtedly be facilitated by vigorous and timely implementation of the additional measures that had been announced for the remainder of the year. Approval would also require further strengthening of the adjustment effort, in order to meet the objective of medium-term balance of payments viability. Over those observations and reservations, he supported the staff appraisal and the proposed decision.

Mr. Enoch stated that the staff paper presented a frank account of developments in the Gabonese economy, as well as a clear description of the difficulty of the adjustment task in the context of a fixed exchange rate system. As his chair had noted in the past, the maintenance of that constraint made effective adjustment significantly more difficult. As Mr. Mawakani had noted, the needed adjustment had indeed been dramatic, given the decline in real GDP, which had been 17 percent in 1987 alone. The authorities had taken a number of useful measures toward adjustment. Nevertheless, it seemed that the current review repeated somewhat the Board's last review, as Gabon's program had veered off course again, and the authorities had had to introduce a number of new measures to bring it back on course. The authorities had again resorted to an agglomeration of ad hoc measures, rather than to the sort of systematic action that would seem to be necessary to sustain the measures over the medium term.

His first major area of concern was with respect to progress on export diversification, Mr. Enoch continued. Mr. Mawakani had said that the Gabonese authorities were aware of the need for a global plan to bring about export diversification, but the staff paper had indicated that very little progress had been made in that crucial area. External debt was being accumulated at an unsustainable rate. He was also concerned about fiscal policy. While he welcomed the measures that had been taken to broaden the revenue base and the significant progress that had been made in reducing the salary bill, the new measures on revenue and expenditure that were being introduced would only serve to correct part of the slippage from the policy targets in the early part of the year, and the performance criteria for end-June might well not have been met, as the staff had made clear. As had been recognized during earlier discussions of the Gabonese program, there was no margin for slippage, given the very drastic adjustment that was needed, and the limited number of instruments which the authorities had at their disposal for achieving the adjustment. The slippage on the fiscal front was therefore particularly regrettable, especially as it was not the first time such slippages had occurred.

More fundamentally, Mr. Enoch went on, he had been greatly puzzled about why the Board was being asked to endorse the proposed decision, since it was likely that the performance criteria for end-June had not been met. If the reason was because of the timing of finance, it would have been more appropriate procedurally to have applied for a waiver. He would be interested to know whether the procedure that was being suggested was a conventional response to the breaching of performance criteria. The performance criteria were designed as key elements to ensure the implementation of conditionality. He also strongly endorsed Mr. Goos's question as to whether full disbursement was warranted under the present circumstances.

The Fund and the Gabonese authorities were shortly to enter into discussions on an arrangement to succeed the current one, and the authorities evidently hoped for access to the extended Fund facility, Mr. Enoch observed. However, he recalled that during the Board's discussions on the revitalization of the extended Fund facility, it was argued that access should be limited to those countries with a good track record. Gabon did not have such a record at present. The authorities needed to ensure that they could begin to establish one through performance under the remainder of the stand-by arrangement. A successor arrangement would then need to address systematically the questions of expenditure control and the structural reform of the budget, including a broadening of the non-oil revenue base through a comprehensive tax and tariff reform, retrenchment in current expenditures--especially in the civil service--and decisive restructuring of the parastatal sector, in accordance with a clear timetable of specific actions. Those measures would need to be complemented by more urgent and broader structural reforms to achieve a reduction in costs, particularly of wages, and to begin the significant diversification of the export base.

Mr. Rieffel made the following statement:

We generally share the staff's assessment of Gabon's performance since the second review, and of the areas where there is a need to further strengthen policies and improve policy implementation.

At the time of the second review of the stand-by arrangement, we said that a stronger effort toward necessary macroeconomic and structural reforms not only was desirable, but appeared feasible. We also noted that effective implementation of measures to contain the civil service wage bill would be critical to the success of the program for 1988. From this perspective, we were keenly disappointed by the slippages in the first half of this year, and we welcome the steps taken by the authorities in midyear to keep the program on track.

We have noted in the staff report that the authorities intend to request the Fund's support following the expiration of the stand-by arrangement, and Mr. Mawakani has mentioned the possibility that the authorities will request an arrangement under the extended Fund facility. I would like to make three points in this regard.

First, we have consistently taken the position that arrangements under the extended Fund facility are only appropriate in cases in which there is a solid track record of implementing economic policy reforms. Given the mixed results of Gabon's adjustment efforts in the past two years, we would favor consideration of an extended arrangement a year from now, on the foundation of a stand-by arrangement for 1989, and with clear evidence that performance criteria for December 1988, March 1989, and June 1989 had been met. This would also give the authorities more time to work with the staffs of the Fund and the World Bank on a comprehensive and coherent medium-term framework for implementing structural reforms that will lead to growth without the need for exceptional external financing.

Second, a major challenge to Gabon in strengthening its balance of payments appears to be reducing the cost structure, in order to make non-oil exports more competitive. The most effective instrument for adjusting the cost structure in Gabon may well be the exchange rate. If this instrument is not available, then a substantial reduction in the public sector wage bill assumes critical importance. In this connection, we have noted that the 1989 budget is being prepared, and that the staff has suggested limiting the civil service bill in 1989 to CFAF 99 billion. We believe that the authorities should aim for an even lower limit.

Third, we welcome the support of the World Bank in the restructuring of the public enterprise sector. We continue to feel, however, that the pace of reform is on the slow side, and we hope that it can be accelerated in 1989.

I share the concerns expressed by Mr. Goos and Mr. Enoch on the phasing of purchases in light of the information we have been given about the performance criteria for June 1988. We support the proposed decision.

Mr. Hogeweg stated that he, along with others, had been worried by the staff report. It painted a vivid picture of the inadequate implementation of a program, especially in the budgetary area. It appeared that only an injection of foreign financing had permitted the observance of the performance criteria for end-March 1988. Moreover, what was especially worrying, the urgent measures that had recently been introduced had been initiated only in the context of the Fund's current review of the stand-by arrangement. As it appeared that the performance criteria for June 1988 would not be met, and as it was anticipated that oil revenues would be zero in 1989, the outlook was not at all reassuring. It was also depressing to learn that the slippages in policy implementation which had occurred implied that no tangible improvements could be expected for the time being. As he had said before, such a situation created a climate in which adjustment fatigue could thrive.

He agreed entirely with the staff that forceful measures were now required to address the difficult situation that was expected in 1989, Mr. Hogeweg went on. He could also agree that performance under the current program would be a key feature in assessing the advisability of a successor program. Furthermore, even if the current stand-by arrangement ended well--to the extent that the revised performance criteria were met--he believed, unlike Mr. Mawakani, that it would be an insufficient base from which to launch an arrangement under the extended Fund facility. In view of Gabon's fiscal record, he believed that quarterly performance criteria were very much needed. As Mr. Enoch had said, an arrangement under the extended Fund facility was only appropriate for those countries which had shown themselves able to pursue sustained adjustment. Gabon did not qualify in that respect at present.

The staff representative from the African Department stated that the measures that had been identified in the context of the review of the stand-by arrangement, and which were being implemented, would have the effect of returning the budgetary situation to very close to what had been initially specified for 1988. The difference, of CFAF 5 billion, amounted to about 1/2 of 1 percent of GDP. Another aspect of divergence from the original 1988 program was the amount of resources that the staff had identified as being necessary for restructuring the public enterprise sector. Comparison of budgetary expenditure figures the staff had used in the current review with those in the second review needed to take into account the fact that CFAF 12 billion had currently been identified as part of the public enterprise sector reform, following the approval of a World Bank structural adjustment loan for Gabon in April 1988. Also, while the performance criteria for end-March 1988 had been met without an exceptional inflow of foreign financing, there had been a question of the timing of the disbursement of two foreign loans, which had been shifted from end-December 1987 to early 1988. However, the performance criteria which had been specified for 1988 had taken that timing difference into account.

With respect to the phasing and the amount of Fund resources to be made available, the staff representative concluded, the staff's assessment was that considering the policy measures and adjustments that were being taken, the objectives of the program that had been initially specified in 1986 were still appropriate, and that the amount of Fund resources that would be available in support of the program should be retained. In the original program design, the last purchase under the program was related to the end-September 1988 test date.

The Deputy Director of the Exchange and Trade Relations Department recalled that Mr. Enoch had raised the question of whether the decision the staff was proposing constituted the conventional response to Gabon's circumstances, or whether it would have been better to have applied for a waiver. The official data for end-June 1988 were not available, but as could be seen from the change in the performance criterion for end-September 1988, it was not likely that the Gabonese authorities would have been able to meet the June performance criteria given the slippages that had occurred, and the timing of the remedial action that had been needed to address them. The staff could have decided to ask the Board for a waiver later, but the staff had believed that it would be better to inform the Board that it would be unlikely that the Gabonese authorities would be able to meet the performance criteria, while stressing that the measures they were taking would have the effect of bringing the program back on track by the end of the year. The decision had been made in light of the fact that the staff would be recommending the completion of the review of the arrangement. She agreed with Mr. Enoch that that approach was not conventional.

Mr. Goos stated that the revisions to the figures for the overall deficit of the Government for 1987-88 appeared to him to have been very large, and he had referred to them as deviations. He recalled that the previous revision of the program targets had also been due at least partially to program slippages. His chief concern was with repeated program deviations that were due at least partly, if not largely, to policy slippages.

Mr. Mawakani observed that, with respect to program deviations, it was the Fund's practice, on the occasion of the review of the program, to make corrections if the need to make revisions to the targets became evident at that time. Such had been the case for Gabon. As the staff had stated, the fundamental elements of the program had been kept, despite the slippages in implementation that had occurred in 1987 and at the beginning of 1988. The authorities had taken measures to correct those slippages. In the letter from the Minister of Finance of Gabon, the authorities had confirmed their commitment to continue the adjustment effort, which was the reason they wished consideration to be given to the possibility of an arrangement under the extended Fund facility. He wished to emphasize that the slippages that had occurred had also been the result of the delay in the disbursements of loans from the banks, as well as of the fluctuation in the price of oil. That notwithstanding, the Gabonese authorities recognized the weaknesses in program implementation and had taken measures to remove them. The authorities were committed to continuing their efforts at collaboration with the Fund and the World Bank. They had recently requested an economic restructuring loan from the World Bank.

The Acting Chairman then made the following summing up:

> Directors generally agreed with the thrust of the staff appraisal. While noting that significant progress had been made in reducing the financial imbalances stemming from the severe deterioration in Gabon's terms of trade in 1986, Directors remarked that much remained to be done to bring Gabon's economy back onto a sustainable growth path. Government expenditure--notably investment expenditure--had been sharply reduced, but since government revenue had declined in step, the 1987 budgetary outturn had been disappointing, with a deficit in excess of the program target that had required sizable external financing. Economic activity, especially in the non-oil sector, had declined sharply.
>
> Directors expressed concern over the slippage in budgetary performance in 1987, and underscored the difficulties that such a legacy could leave for attaining the 1988 program targets. They noted that those program targets had had to be revised to reflect the altered time profile of adjustment during the year, taking into account the additional measures that had been belatedly adopted to return the program onto a viable adjustment path. Those measures included the collection of tax arrears, cuts in and controls on government expenditure, and reductions in the salary bills of the parastatal enterprises. Directors stressed that the effective implementation and monitoring of those measures, and related structural policies, were essential

for the success of the 1988 program and the achievement of the authorities' medium-term objectives for growth and the balance of payments. The earlier delays in implementation, the greater recourse to financing, and the uncertain prospects for oil prices left virtually no room for slippage in the implementation of appropriate policies. Some Directors observed that additional measures in the fiscal sphere might be needed, including comprehensive tax reforms and efforts to bring the informal sector into the existing tax system.

Directors regretted that the pace of implementation of necessary structural measures, involving, notably, a reduction in labor costs, a revival of the rural economy, and diversification of the productive base, had been slow. While recognizing the considerable efforts of the authorities in addressing those issues and the time needed to elaborate structural adjustment programs with external assistance, Directors felt that high priority should be given to accelerating parastatal reforms, establishing clear and firm guidelines for a restrained wage policy, rationalizing the public investment program, and implementing restrictive domestic credit policies.

Directors emphasized that, in view of Gabon's exchange arrangements, further fiscal adjustment was necessary, and that the high wage cost structure should be reduced and external financing limited so that medium-term balance of payments viability could be achieved. The authorities were urged to implement the needed corrective measures with speed, as experience under the present Fund-supported program had shown that the implementation of such measures could be time consuming.

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

The Executive Board then took the following decision:

1. Gabon has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement for Gabon (EBS/86/269, Sup. 1), and as contemplated in paragraph 4 of the letter of the Minister of Economy, Finance, and Participations dated November 26, 1986 attached to the stand-by arrangement, in order to review performance under the 1986-88 program.

2. The letter from the Minister of Finance, Budget, and Participations dated July 29, 1988 shall be attached to the stand-by arrangement for Gabon, and the letters of November 26, 1986, June 29, 1987, and December 29, 1987 shall be read as modified and supplemented by the letter dated July 29, 1988.

3. Accordingly, the reference in paragraph 4(a) of the stand-by arrangement to paragraph 26 and Table 1 of the memorandum annexed to the letter dated November 26, 1986 (relating to the performance criteria on net domestic assets and net credit to the Central Government) which comprehends a reference to paragraph 20 and the table attached to the letter dated December 29, 1987, shall also comprehend a reference to paragraph 15 of the letter of July 29, 1988.

4. The Fund decides that the third review contemplated in paragraph 4(c) of the stand-by arrangement is completed, and that, notwithstanding paragraph 4(a) of the stand-by arrangement with respect to end-June 1988 performance criteria, Gabon may proceed to make purchases under the stand-by arrangement, provided that such purchases shall not exceed the equivalent of SDR 73.1 million until November 14, 1988.

Decision No. 8987-(88/150), adopted
September 16, 1988

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/88/149 (9/16/88) and EBM/88/150 (9/16/88).

5. 1988 ANNUAL MEETING - EXECUTIVE BOARD - REPRESENTATION EXPENSES

The Executive Board approves the recommendation of the Committee on Executive Board Administrative Matters concerning representation expenses at the time of the 1988 Annual Meeting as set forth in EBAP/88/229 (9/14/88).

Adopted September 16, 1988

APPROVED: April 7, 1989

JOSEPH W. LANG, JR.
Acting Secretary