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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/102

10:00 a.m., June 29, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	S. M. Hassan, Temporary
F. Cassell	C. Enoch
	D. Barr, Temporary
Dai Q.	
C. H. Dallara	E. L. Walker, Temporary
	J. Prader
A. Donoso	E. V. Feldman
	S. K. Fayyad, Temporary
	B. Goos
	R. Wenzel, Temporary
J. E. Ismael	
	J. Hospedales
	J. R. N. Almeida, Temporary
M. Massé	
	D. Saha, Temporary
Y. A. Nimatallah	I. A. Al-Assaf
	B. Fuleihan, Temporary
	L. Filardo
	M. Fogelholm
	D. Marcel
	G. Pineau, Temporary
G. A. Posthumus	G. P. J. Hogeweg
	C.-Y. Lim
	C. Y. Legg, Temporary
	M. A. Hammoudi, Temporary
A. K. Sengupta	
	N. Adachi, Temporary
	N. Kyriazidis

L. Van Houtven, Secretary and Counsellor
R. Gaster, Assistant

Also Present

IBRD: H. Messenger, Africa Regional Office; J. B. Sokol, Latin America and the Caribbean Regional Office. African Department: G. E. Gondwe, Deputy Director; J. Artus, C. V. Callender, K. B. Dillon, J. K. M. Kinyua, T. R. Muzondo, T. van der Willigen. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; A. Basu, S. Kanesa-Thasan. Fiscal Affairs Department: G. M. Bartoli. Legal Department: H. Elizalde, A. O. Luiksila, J. K. Oh. Research Department: J. A. Frenkel, Economic Counsellor and Director, A. D. Crockett, Deputy Director. Secretary's Department: C. Brachet, Deputy Secretary. Treasurer's Department: D. V. Pritchett. Western Hemisphere Department: S. T. Beza, Director; J.-P. Amselle, M. A. Da Costa, S. J. Stephens, M. A. Tareen, K. Thugge, G. Yadav. Advisors to Executive Directors: P. E. Archibong, A. G. A. Faria, P. Kapetanovic, M. Pétursson, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: S. Appetiti, H. S. Binay, R. Comotto, F. El Fiky, V. J. Fernández, J. Gold, M. Hepp, L. Hubloue, A. Iljas, V. K. Malhotra, W. K. Parmena, S. Rebecchini, C. C. A. van den Berg.

1. TORONTO SUMMIT - EXCHANGE OF VIEWS

The Executive Directors informally exchanged views on the economic summit meeting of the Group of Seven, held in Toronto on June 21, 1988. (see Toronto Economic Declaration, EBD/88/174, 6/23/88).

Mr. Massé said that he had no mandate from his authorities to discuss confidential matters from the summit. There had been a review of economic cooperation, emphasizing the extent to which cooperation had taken place. The Ministers of Finance and heads of government clearly realized that cooperation was now a necessity, not a choice.

It was recognized that resolution of the problem of the lowest income countries' debts was important, reflected in the proposals made by Chancellor Lawson, President Mitterrand, and the Canadian delegation, Mr. Massé continued. The summit communiqué did not announce a resolution of the problem, but it did indicate that all the G-7 countries were ready to move on that question, and that the Paris Club now had the ability to offer the equivalent of concessional interest rates.

There had been many rumors, and two or three schemes on debt reduction for middle-income countries had been discussed at lower levels, but none had reached the heads of government level, and were certainly not mentioned in the communiqué, Mr. Massé observed. So, there was still no international agreement on debt reduction schemes for the middle-income countries.

Discussions on agricultural policies within the framework of the Uruguay Round had been quite significant, and had started months before the summit, Mr. Massé remarked. The general interpretation was that the words included in the communiqué indicated no victory for those who wished to end agricultural subsidies by the year 2000, and that the summit communiqué itself reflected little improvement on the OECD ministerial communiqué--leaving the problem in place for the mid-term review of the Uruguay Round that would take place in Montreal in December. By then, it was quite possible that the agricultural question would become a crucial issue and would lead to further conflict. It could, therefore, continue to create considerable problems at the level of the heads of governments.

Mrs. Filardo asked whether it was possible to know the details and source of the schemes for resolving the debt problems of middle-income countries mentioned by Mr. Massé.

Mr. Massé replied that most of the schemes concerned extensions of a menu of options. The general view was that those schemes should be voluntary, market based, and operated on a case-by-case basis. Some of the schemes included guaranteed financing, and others did not; some included contributions by creditor governments and others did not. Those examined in Ottawa were only those that did not involve a nondiscretionary contribution by creditor governments, and that were market based--extensions of the Mexican scheme. In other words, summit participants had looked at the possibility of guaranteeing the entire capital involved--as the Mexican scheme had done--and also interest rates.

The Finance Ministers had concluded that no scheme had reached a state that could be endorsed by them or chosen for further study under their guidance, Mr. Massé continued. In fact, a sentence had been added at the end of paragraph 27 of the communiqué that generally endorsed a search for still more options, while a further sentence meant that the Ministers of Finance, after looking at the schemes, were not yet satisfied with their characteristics. Consequently, no sustained attention had been given to any scheme at the level of heads of government.

Mr. Posthumus remarked that the communiqué reflected a rather significant set of conclusions and commitments from the participating countries, a real contribution to the financial and economic development in the world. Also, his own recent warning against complacency could now be found in the communiqué itself.

The communiqué did not, however, mention the role of the Fund in the international monetary system, Mr. Posthumus continued. Nor did it discuss the role of the Fund in the surveillance of the economies of member countries. He hoped that the Group of Seven would in the future work to strengthen those two specific roles, because the Fund was not only a lending agency, however important that role was; it also had a function in the international monetary and financial system. Indeed, representatives at the summit could point out to their authorities that there was an important role for the Fund in those areas, not least in connection with countries not represented at the summit which would undoubtedly wish to discuss and comment on proposals issuing from the summit before decisions were taken--a point that should be taken as a request and not as criticism. It was important to remember that coordination developed and grew organically, rather than being decided at a given moment.

The text of the communiqué contained--in paragraph 13--a certain preference for the maximum freedom of capital movements, Mr. Posthumus observed. Of course, that required the use of monetary policy, and perhaps also exchange rate policy, to control the spreading of disturbances. He wondered whether that reflected a preference for the freedom of capital movements over exchange rates stability. Finally, he wondered whether representatives of the Fund were in any way involved in the preparation of the policy proposals that were submitted to the heads of state.

Mr. Sengupta said that he supported Mr. Posthumus's comments on the surveillance role of the Fund. The Board should also consider the summit in the same way that it considered exchange rate questions; he was pleased that such discussions had become an institutional feature within the Fund.

On the question of reducing the debt of developing countries, it was important to understand the details of any decision that might emerge from the summit, or even the direction in which summit participants were moving on that issue, Mr. Sengupta observed. He wondered whether any agreement had been reached about the method of approach to be adopted.

The question of the freedom of capital movement had important implications for the coordination of monetary policies, and he wondered whether any specific framework was under consideration, Mr. Sengupta continued. While Mr. Massé had said that cooperation was now inevitable, was a specific institutional framework for that cooperation being discussed, or was there merely a general feeling or consensus that movement should be made in that direction? It would also be interesting to know more generally the views of the Group of Seven on the direction in which the international economy was likely to move.

Mr. Nimatallah said that he appreciated the commitment of the G-7 members to the need for continued summit conferences, as the success of summit conferences had had international repercussions. Certainly, the participants appeared to appreciate that point, as reflected in paragraphs 4 and 34 of the communiqué, which emphasized the significance of the summit and of the annual meetings of the Fund and the World Bank. With regard to the summit meetings, the efforts of the Reagan Administration, and particularly of Secretary Baker, deserved special credit. He hoped that management and Mr. Dallara would convey to the incoming U.S. Administration, soon after it took office, the Board's hope that summits would continue with the same vigor and the same commitment to improving the international economic environment.

He also commended the Group of Seven's commitment to economic reform, which was reflected in several areas, particularly paragraph 10 of the communiqué, Mr. Nimatallah said.

A third important and commendable point was made in paragraph 22 of the communiqué, Mr. Nimatallah noted, namely that "central to the prospects of the developing countries are a healthy global economic environment and an open trading system, adequate financial flows and, most important, their commitment to appropriate economic reform." It was most significant that the key industrial countries had recognized the importance of a healthy global economic environment for the prospects facing the developing countries. That environment notably included financial policies and their impact on interest rates and hence on the debt problem.

Two other points were less encouraging, Mr. Nimatallah remarked. First, no tangible progress was visible on agricultural policies. He had been hoping to see something similar to the reforms suggested by the Reagan Administration, a process that would take a decade or even more but that would at least now begin. He did hope that by 1992, with the unification of the European market, the problem of trade in agriculture would be easier to alleviate. Second, he noted that paragraph 22 of the communiqué went on to say that "the problems of many heavily indebted developing countries are a cause of economic and political concern and can be a threat to political stability in developing countries. Several countries find themselves in that situation in various regions of the world..." That was perfectly true, but there was no reason to limit the list of regions that followed, to Latin America, Africa, and the Pacific. A number of countries in the Middle East faced precisely those circumstances; hence, he objected quite strongly to the inclusion of the list of regions.

Mr. Donoso said that the Group of Seven had strongly welcomed the free trade agreement between the United States and Canada, and he wondered whether the implications of that agreement could be further clarified.

Mr. Dallara commented that the Toronto summit had been particularly significant partly because it had been President Reagan's last summit, and because it marked the completion of the second cycle of economic summits. It had been an opportunity to reflect upon some of the progress and successes of the 1980s, including the sharp reductions in inflation rates, the removal of many market barriers in many countries, and the movement toward more efficient tax systems. There was, however, also clear acknowledgement of the seriousness of the problems that remained and the need to avoid complacency.

Within the context of the comments made earlier by Mr. Massé, three points in the area of policy coordination needed to be emphasized, Mr. Dallara continued. They related particularly to the framework of the coordination process, which needed to be strengthened. First, the addition of the commodity price indicator was of some additional although marginal importance. Second, the summit countries had acknowledged that the progress achieved in coordination had itself contributed to the process of improving the function of the monetary system--an important acknowledgement by the heads of state. Third, the coordination process had given increased attention to the need for structural reform within the summit countries--including, notably, the commitment of the heads of state to review structural policies collectively, and to strive to integrate these policies into the coordination process.

There was no lack of appreciation for the Fund's role, despite the absence of an explicit reference in the communiqué, Mr. Dallara stated. Within his own Government, discussions were already being held on possible ways for the Fund to play an important role in advancing some of the objectives articulated in the communiqué, in terms of strengthening the coordination process.

Agricultural policies did indeed constitute the most difficult issue discussed at the summit, Mr. Dallara remarked. They were an emotional issue for summit participants. The outcome had been something of a stalemate between the parties firmly committed to elimination of trade-distorting agricultural subsidies by the year 2000, and the parties that believed that to be an unrealistic and inappropriate objective. The debate would continue largely within the trade policy community, but he did wonder whether the Fund itself needed to consider a more active role in encouraging constructive dialogue and action in that area. Agricultural policies could be given more attention in some Article IV consultation discussions with major industrial countries, for example. The issue was a critical one, and he sensed a greater diversity of views on it among summit countries than on any other important economic issue.

A clear sense had emerged among the summit countries on the need for closer dialogue with the newly industrializing economies, as well as on the need for cooperative action among the Group of Seven, Mr. Dallara noted. Of course, that dialogue would not be easy given the political circumstances of some of the newly industrializing economies.

He had little to add on the subject of middle-income countries' debts, Mr. Dallara remarked. So far as the debts of the poorest countries were concerned, the summit marked a very important advance, under the leadership of the Canadian delegation along with the earlier initiatives by the United Kingdom and France. A clear consensus had emerged on the need for exceptional debt relief for a category of low-income debtors. The exact nature of the debt relief would have to be discussed with the other creditors, and within the Paris Club. A working group of the Paris Club would meet in mid-July, involving not just summit participants but all countries affiliated with the Paris Club. Those countries not participating at the summit would need to consider whether they wished to accept that general consensus, and if so, then the Paris Club would need to resolve specific details. That would not be easy, because achieving comparability with respect to the various debt-reduction options of longer maturities and reduced interest rates--essential trade-offs--would not be easy. From the perspective of the Fund, the summit communiqué was an important advance which would enhance the prospects for balance of payments viability in many of the countries able to take advantage of the additional concessions.

The sentence in paragraph 22 of the communiqué that had concerned Mr. Nimatallah, listing various regions of the world, was the result of an awkward political debate among heads of state, Mr. Dallara continued. The debate had been initiated by his authorities which had sought some particular reference to the Philippines. Other heads of states had responded by mentioning other important countries. The eventual compromise had left everyone more or less dissatisfied, and it was fair to suggest that the whole reference to regions and countries was rather awkward.

Mr. Massé commented that the Fund had had a considerable role in preparations for summits. For instance, in 1987, before the unveiling of the enhanced structural adjustment facility, the Managing Director had traveled to meet heads of state or of governments around the world. The new facility would not have been on the agenda of the summit in 1987 without the specific involvement of the Managing Director and hence the Fund.

In the course of preparations for the recent summit, the Managing Director had held discussions with both heads of state and other summit participants on low-income countries' debt, middle-income countries' debt, the question of policy coordination, and the role of the Fund in the international monetary system, Mr. Massé continued. Hence, all Directors were represented in the summit perhaps in an informal and indirect way; they did influence the content of the communiqué. The Fund also had a direct influence on all the heads of government that were involved in discussions at the summit. In the past, the summit communiqué had strongly reflected--for instance, in the discussions of the enhanced structural adjustment facility and low-income countries' debt--the discussions, conclusions, and views that had been expressed in the Board.

It was important to remember that the Managing Director was himself present during deliberations of a number of items on the agenda of the Group of Seven, and that the Economic Counsellor and Director of the Research Department, for instance, had given extremely important input into those deliberations, Mr. Massé remarked. Hence, here too the Fund had an important channel of intervention into the G-7 deliberations.

The strong welcome given to the free trade agreement between the United States and Canada was partly a response to fears expressed that the agreement might adversely affect the multilateral trade negotiations or the multilateral system, Mr. Massé continued. In fact, the agreement had been designed to enhance multilateral trade negotiations. The Canadian authorities were particularly conscious, as a middle-level power, that they were protected by the rules of the game, and they therefore knew the importance of a multilateral system and of multilateral trade rules. His authorities had used the summit to try to persuade participants that the agreement did not constitute an attempt by Canada and the United States to restrict their trade, or to create their own market, and that both continued to believe that multilateral trade rules would continue to predominate.

The Acting Chairman remarked that the Managing Director's involvement in meetings of the Ministers of the Group of Seven drew heavily on discussions in the Board of the world economic outlook, individual Article IV consultations, and sometimes on exchange rate developments.

Mr. Hassan commented that all welcomed the recognition and endorsement by the summit participants of the need for exceptional relief schemes for the poorer countries. That represented a real and positive step, and a departure from the traditional debt relief approach.

Expectations had, however, been raised that the summit participants would adopt a more specific or defined strategy to address the problems of those countries, Mr. Hassan continued. Those expectations had emerged from the publicity given to the specific proposals made by a number of the G-7 countries. Hence, some of the poorer countries felt uneasy that no specific strategy had in fact been adopted. Nonetheless, the communiqué did clear the way for countries that wished to move in the direction of such relief, and he hoped that all G-7 countries would move as quickly as possible to translate their endorsements into action.

The indebtedness of the poorest countries to multilateral institutions represented a major part of their total debt, Mr. Hassan observed. At some point there would be a need to address the indebtedness of those countries to multilateral institutions, because without finding a way to resolve that part of the debt, the debt problem could not be resolved.

Mrs. Filardo commented that the communiqué contained more negative results than positive ones. While it noted that the world had experienced the longest period of economic growth in postwar history, the world still faced greater exchange rate instability, debt service difficulties in a number of developing countries, serious problems in Africa, and political and social unrest in Latin America. Hence, the congratulatory tone of the communiqué seemed based on a rather rosy perspective.

The question of Fund participation in the G-7 process was a very important one, Mrs. Filardo considered. The clearly informal nature of that participation had perhaps led to problems of communication. While the staff and the Managing Director seemed well informed, that was not true of Executive Directors from nonparticipating countries. Perhaps the Fund should be participating officially.

Mr. Sengupta said that the Managing Director's involvement in the Group of Seven had given the Fund a substantial, if informal, foothold in the international discussions; certainly, there was little to be done if the summit leaders did not choose a more forthright involvement. He welcomed the efforts made by the Managing Director in relation to the Group of Seven, and thought that his participation did, to a large extent, reflect Board discussions.

The communiqué's comments on exchange rates had included a most interesting sentence, Mr. Sengupta remarked. The sentence read "we endorse the Group of Seven's conclusion that either excessive fluctuation of exchange rates, a further decline of the dollar, or a rise in the dollar to an extent that becomes destabilizing to the adjustment process could be counterproductive by damaging growth prospects in the world economy." That sentence implied that the summit participants thought that the dollar should not decline further. It could rise, but not to the extent that it destabilized the system. He wondered whether that precise reading was justified, or whether the sentence resulted from a compromise of some sort.

With regard to the debt of the poorest countries, President Mitterrand's statement had been very bold, Mr. Sengupta continued. President Mitterand had called for an immediate cancellation of one third of the debt within the framework of consolidation agreements, debt consolidation at market rates but with maximum duration of twenty-five years, and preferential interest rates reduced by at least half over a repayment period on the order of fifteen years.1/ Those were concrete suggestions, but it was not yet clear whether they would be implemented. The Paris Club had, in the communiqué, been urged to work out any necessary technicalities to ensure comparability by the end of 1988. Comparability referred to the framework of comparison that allowed official creditors to choose between concessional interest rates--usually on shorter maturities--longer repayments at commercial rates, or partial write-offs of debt service obligations during the consolidation period. The sentence in the communiqué gave the impression that the summit was giving approval of some kind to the Mitterrand approach, and was asking the Paris Club to work out the appropriate modus operandi. He wondered whether that was a correct interpretation.

Mr. Dallara observed that it had been the unanimous view of the summit countries that the free trade agreement between the United States and Canada was a positive step for the world trading system. He was certainly prepared to address specific questions and concerns on the agreement in the context of the Board's discussion of the staff report for the Article IV consultation with the United States when it came to the Board in late August. At that time, he could explain in detail why his authorities saw the agreement as being fully consistent with their multilateral obligations, and why they hoped that the agreement would catalyze the process of global trade liberalization.

It was important to remember that some parts of communiqués were not negotiated by finance ministry officials, Mr. Dallara continued. Hence, the natural inclination had simply been to pick the language concerning exchange rates directly and exactly out of the G-7 communiqué of December 22, 1987, because that sentence in the communiqué had been highly negotiated and rather delicately framed. There had, consequently, been little enthusiasm to reshape the sentence at the Toronto meeting. Despite rather significant exchange rate changes in the interim, it was felt that the safest and most reliable approach was to use the December 22 communiqué language. In hindsight, while that approach had been entirely reasonable, it might have sent some unintended signals.

So far as he understood, the proposals made by President Mitterrand remained very much alive as part of the options which were to be developed further by the Paris Club, Mr. Dallara concluded.

Mr. Goos remarked that so far as the interpretation of the communiqué was concerned, he agreed with the comments of Mr. Massé and Mr. Dallara. That included their interpretation of the sentence on exchange rate stability. The sentence essentially reflected the recognition of summit participants of the advantages of exchange rate stability; at the same time, there had never been an intent to pin down exchange rates to a

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1/ See extract from letter of President Mitterand to heads of state or government (EBD/88/168, 6/16/88; and Cor. 1, 6/20/88).

specific point, which would exclude a margin for exchange rate movements in both directions when appropriate. Fundamental changes expressed through market pressure could not be resisted.

While he sympathized with the calls made by some Directors for closer Fund involvement, he supported the comments of Mr. Massé and Mr. Dallara on the indirect involvement of the Fund in the recent summit process, Mr. Goos continued. It should, however, be remembered that the summits were in the last instance encounters of the heads of states, aimed at exchanging views on the most serious problems that currently confronted them. The world economy, and the G-7 economies in particular, appeared on the agenda. The apprehensions expressed in the Board contrasted somewhat with press criticisms that the summits were nonevents because no decisions came from them. However, summits could not be expected to take decisions on behalf of the Fund, as participants could not bind nonparticipating countries. Hence, many of the issues addressed at the summits belonged, in the end, on the agendas of other institutions, including that of the Fund, where the final decisions were taken.

Mr. Dai remarked that he saw the communiqué as a political declaration, rather than as an economic report, which largely explained the balance of the recent communiqué.

The Chinese had an old saying, that people should be judged not by their words but by their actions, Mr. Dai continued. Hence, he was more concerned about action than about the language used in the communiqué. In that connection, the Group of Seven had made a commitment to the enhanced structural adjustment facility at the Venice summit in 1987. In 1988, most members of the Group of Seven had taken some welcome actions related to that development. There had also been some useful outcomes from the Toronto summit, most notably the impressive paragraph on the debt problems of the poorest countries. He looked forward to seeing some positive results in the period ahead.

Mr. Pineau commented that the problem of comparability raised in connection with the proposal made by President Mitterrand existed on two levels. First, there was the problem of comparing the three options available within the Mitterrand proposal. His authorities had a clear preference for the option that immediately reduced the debt burden of the poorest countries, but it was certainly important to consider the other two options. The second comparability problem arose in relation to the proposals made by the U. K. Chancellor of the Exchequer, Mr. Lawson, and the Canadian authorities in addition to those of President Mitterrand.

As his authorities were also currently chairing the Paris Club, it was quite natural that the debate or discussions on the various proposals would take place within the Paris Club framework, Mr. Pineau commented. Exact comparability would certainly be difficult to establish, and that was why the development of a final set of formulas treating the poorest countries' debt problem could take until the end of 1988.

Mrs. Filardo observed that while the summit was indeed a political meeting for the interchange of views, she remained concerned about enhancing Fund participation in the G-7 meetings.

The Acting Chairman remarked that at the Versailles Summit meeting of 1982, the first steps had been taken to involve the Managing Director in what was then the Group of Five, which had eventually expanded to become the Group of Seven. During the current cycle of summit meetings, the role of the Fund had become much more explicit and much more transparent than had been envisaged during the first tentative steps in 1982. There had, therefore, been a considerable evolution in the direction of more explicit involvement, and he expected that evolution to continue.

The summit process was a relatively lengthy one, the Acting Chairman remarked. Indeed, preparations were probably already under way for the next summit meeting. The meetings and discussions involved over the course of a year allowed some opportunity for Fund input, in addition to that offered by the Interim Committee meetings.

Mr. Posthumus said that he agreed with the Acting Chairman's comments, but noted that in some way the Board should itself be involved in the summit process. That involvement had to some extent been neglected in the past. However, such a change would be the responsibility of the Executive Directors themselves.

The Executive Directors concluded their informal exchange of views at the Toronto Economic Summit.

2. LESOTHO - STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered a staff paper on Lesotho's request for a three-year arrangement under the structural adjustment facility in an amount equivalent to SDR 9.6 million (EBS/88/107, 6/3/88). They also had before them a medium-term policy framework paper on Lesotho (EBD/88/153, 6/6/88), and the following statement from the Managing Director (EBD/88/116, 6/29/88).

The Managing Director made the following statement:

> There follows for the information of Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and IDA in their June 14, 1988 discussion in Committee of the Whole of a paper entitled "Lesotho: Policy Framework Paper, 1989-91."
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> The Committee of the Whole commended the Government of Lesotho for its timely efforts to deal with its economic and financial imbalances before the situation became intractable.

It was seen as essential to reduce Lesotho's dependence on South Africa for migrant worker earnings and customs receipts. In this respect, speakers supported the aim of the policy framework paper (PFP) to create employment opportunities in Lesotho. Because of its inevitable links with South Africa, Lesotho was circumscribed in its use of independent monetary, exchange rate, and trade policies. Thus, Government had rightly concentrated on the available economic management tools--namely, public expenditure and sector policy. Improvement in the mobilizing of savings was also seen as essential. Particularly, miners should be encouraged to invest their savings in Lesotho.

The Government was commended in particular for addressing a number of long-term constraints to diversification of the economy, notably in land management and soil conservation. The Committee recognized the long gestation period needed to achieve a number of the objectives of the PFP.

The importance of improved budgetary management was emphasized by the Committee. The Government had shown foresight in recognizing the risks of not having an adequate planning and budgeting system in place when the royalties from the Highlands Water Project are realized.

It was noted that the PFP targets for budget deficit reduction over the medium term could be viewed as ambitious, and it was wondered whether the proposed targets were realistic. The Bank and the Fund, as well as the Government, regard the proposed reductions as difficult but necessary, given resource and absorptive constraints and the need to limit nonconcessional borrowings.

Executive Directors expressed concern about the ability of Lesotho to achieve the domestic growth targets proposed, and to attract the prerequisite private investment. Staff responded that the Government had already begun a number of actions to attract foreign investment, promote greater high-value horticultural crops and other production using locally available resources, and to capture secondary industrial opportunities emanating from the Lesotho Highlands Water Project. Along with increasing GDP growth, promotion of greater trade with countries outside the region was also an objective of the PFP. As regards exports as a whole, the country had in the past demonstrated high levels of growth. With recent industrial investment and improved policies to promote further investment opportunities, the projected growth should be feasible.

Concerning the social impact of measures adopted by Government in the PFP, staff indicated that the Government planned to cushion the program's impact through a range of human resource development and other subsidy programs directed toward the lowest income groups. In addition, an IDA project now being prepared aims specifically to improve nutritional surveillance through outreach programs to help remaining areas where malnutrition exists. The project would work with food aid agencies to improve the targeting of feeding programs. Underspending for education and the consequent decline in the quality of basic education in Lesotho will be addressed in the development of the Government's public investment program for the Fourth Plan period.

The staff representative from the African Department said that provisions in the trilateral and bilateral monetary agreements between Lesotho, South Africa, and Swaziland permitted restrictions on transfers of participants' currencies which were subject to Fund approval under Article VIII, Section 2(e). Those provisions had been amended in order to remove the restrictions, and the amendments were currently in the process of ratification. The Board would be informed on completion of the ratification process, which was due shortly. Should there be a delay, temporary approval of Lesotho's restrictions would be appropriate.

Mr. Hassan made the following statement:

The Executive Board only recently reviewed economic policies and developments in the Kingdom of Lesotho at the occasion of the Article IV consultation in February. At that time, Directors urged speedy conclusion of the negotiations for a structural adjustment program to be supported by an arrangement under the structural adjustment facility as most of Lesotho's problems were of a structural nature. The authorities of Lesotho wish to express their appreciation to the staffs of the Fund and the World Bank for their assistance and collaboration in those preparations which have now culminated in the structural adjustment program for 1988/89 to 1990/91 for which they are seeking assistance under the structural adjustment facility. They are in agreement with the staff analysis and appraisal. This will be Lesotho's first Fund-supported program. Although the authorities would have preferred an enhanced structural adjustment arrangement, they still look forward to the conversion of the present arrangement into an enhanced structural adjustment arrangement in due course.

The program places considerable emphasis on the promotion of the agricultural and industrial sectors where more potential lies for expanding GDP and domestic employment. This is understandable since the root of Lesotho's structural weakness is the narrow production base which compels more than half of the labor force to seek employment outside the country, remitting back incomes which are as large as GDP but which are beyond the authorities' control. At the same time, domestic unemployment is estimated to be increasing by more than 20,000 each year.

The structural adjustment program is already registering initial progress on this front under a financed Land Management and Conservation Project financed by the International Development Association (IDA). Some progress has been made in the design of a more efficient system of land allocation and utilization. The thrust of the reform is the development of legal leasing arrangements to facilitate the possession of land title deeds so as to promote investment and credit for agriculture and livestock production. The program involves also the improvement of land use through the formation of regional grazing associations and the introduction of user charges. Agricultural diversification is being fostered in various ways including the production of high value crops for export. To this end, incentives, extension services, and marketing arrangements are being developed or strengthened.

The Government is providing greater encouragement to the manufacturing sector to which private domestic and foreign investors have so far responded favorably. Some of the stimulus has taken the form of tax holidays, tax rebates, industrial estates, and trade promotion. With respect to some of the incentives, however, such as the lengthening of tax holidays, the Government has decided to undertake a review of the cost-effectiveness of the packages with the assistance of the World Bank. In the meantime, the investment supportive roles of Lesotho National Development Corporation (LNDC) and the Basotho Enterprise Development Corporation (BEDCO) are being further strengthened. In addition, a new Private Investment Unit is being established to provide more services to private investors. The overriding emphasis is to encourage investment in the manufacturing activities for exports and import-substituting industries which generate more employment opportunities. Potential export markets for such locally manufactured goods as wool, mohair fabrics, textiles, shoes, and meat are expected to be found in the framework of the Southern Africa Customs Union (SACU) regional market and the European Communities under Lome III arrangements.

Under the program, the Government has undertaken to reverse the recent deterioration and reduce the deficit from 11 percent of GDP in 1988/89 to about 4 percent by 1990/91. Two major structural weaknesses that have constituted the source of increasing instability have been addressed. One is the heavy reliance on SACU receipts which are not only beyond the authorities' control but fluctuate widely from year to year. In 1987/88, for example, SACU receipts increased by 8.4 percent while in the previous year they had fallen by 9.9 percent. The program aims at diversifying the revenue source. The second is the institutional weakness with respect to the planning and budgeting process resulting in failure to coordinate capital and recurrent budgets and leaving important capital projects to extrabudgetary expenditure. The ultimate effect is that the overall public expenditure lacks well-specified priorities.

The program supported by the structural adjustment arrangement aims at reducing the deficit through substantial structural changes in taxes as a result of which revenues are expected to increase (excluding grants) at an annual average rate of 18 percent while restraining total expenditure growth to an annual average of only 8.2 percent during the three years. This is indeed an ambitious goal. On the revenue side, the tax base will be considerably broadened by expanding the sales tax base. In addition, most government service fees, charges, and licenses will be sharply increased. The authorities expect to increase tax yield significantly by simplifying the structure of individual and company income taxes and improving the effectiveness of the entire tax collection. The greatest potential source of tax revenue, however, will be the new direct tax on miners' income which is about to be finalized and put in place in 1989/90.

On the expenditure side, while pursuing a tight current expenditure policy, the Government will undertake a reform of the civil service with the assistance of the World Bank. The terms of reference of the reform study will be finalized during the first year of the program. In the meantime, civil service salary increases will be limited to the GDP deflator but the main objectives will be the retention of skilled manpower while curtailing contract and casual labor.

With effect from the launching of the 1988/89 budget, the authorities have embarked on work to strengthen the institutional base for macroeconomic and demand management aimed at greater coordination between capital and recurrent budgets and to establish expenditure priorities. This process will be consolidated progressively throughout the program with a view to formulating and implementing national budgets that better reflect government priorities. In this connection the Government has been undertaking, with the assistance of the World Bank, a review of public expenditure that will constitute the basis of the Public Investment Program.

The Government is strengthening the public enterprise sector to ensure that it is self-sustaining without the need for direct or indirect subsidies. As a logical starting point for this exercise, the authorities sought the assistance of the World Bank which responded by undertaking a study of the sector. The Government is considering the main recommendations of that study. However, two policy decisions have been reached. One is the establishment of a Parastatal Performance Evaluation Unit which will oversee and evaluate parastatal performance on a continuous basis; the other is to allow greater flexibility in pricing policy for the public enterprises. Notwithstanding the fact that the Government is still reviewing the recommendations, it has already granted some price increases in those cases where they had clearly lagged behind, such as electricity tariffs, which were raised by 10 percent in February, and water and sewerage tariffs which were increased by 77 percent on average in April. The authorities believe that in the near future tariff increases should reach levels which permit utility companies, such as the power company, to service all their existing debts as well as finance their own future capital investment. The Government is also considering the divestiture of some public enterprises.

The underlying structural weakness in the monetary sector is the continuing excess liquidity alongside a weak private sector credit absorptive capacity. The Government is therefore developing several avenues to enhance credit to productive enterprises such as the leasehold land title deeds which are being developed to provide collateral for farmers' credit. For the manufacturing sector, under the export financing scheme to be introduced in September, the Central Bank will provide refinancing to commercial banks which provide credit to exporters. Other means of promoting productive use of the excess liquidity include commercial paper that will be issued by LNDC with government guarantee effective this year; in the meantime, the Government has decided to continue to issue bonds of smaller denominations suitable for the public.

The migrant worker's miners deferred pay fund constitutes a significant proportion of Basotho savings. However, drawings by miners to invest in higher-yielding assets could threaten its viability. Consequently the Government is considering the establishment of a Board of Trustees for the Fund and appropriate legislation to enable investment of the Fund in higher yielding assets so as to pay the migrant workers more competitive interest rates.

On the external sector, the authorities' objective is to contain the current account deficit and debt service burden. They intend to reduce the current account deficit from its 1988/89 level of 7.0 percent of GDP to 5.5 percent of GDP (3.0 percent of GNP) by 1990/91. They realize that as members of the Rand Monetary Area the room for maneuver lies in their production and fiscal policies. As I have indicated above, therefore, their focus is on measures to promote exports and import-substituting industries. With regard to debt service, the authorities realize that although the present level of debt service, just exceeding 4 percent when expressed as a percent of exports of goods and services, is not yet alarming, it is a source of concern when expressed as a ratio of debt service to exports of goods and nonfactor services at 22.6 percent in

1987/88. The latter ratio underscores the vulnerability implicit in Lesotho's dependence on the exports of factor services--namely, labor over which Lesotho has no control--and hence the need for cautious external borrowing policy. It also underlines the need for concessional financing of Lesotho's development projects.

In concluding, I wish to draw the attention of Directors to the precarious geopolitical position of Lesotho, given what is happening in that region of Africa. Accordingly, the two principal objectives of Lesotho's program have been to raise the GDP annual growth rate average to 4 percent from 2.7 percent in the last three years and to reduce, through considerable fiscal effort, its external vulnerability. The authorities are fully aware that they are embarking on a very ambitious structural adjustment program in terms of growth and social burden, as noted by the Executive Directors of the World Bank and IDA. The impact of fiscal retrenchment in terms of user charges, higher fees, taxes, and sharp reductions in public expenditures on a country with one of the lowest per capita incomes in the world illustrate vividly the social strain of the adjustment program. This underscores the need for concessional financing and the strong case for support under the enhanced structural adjustment facility.

Mr. Enoch made the following statement:

I can support the proposed decision for a structural adjustment arrangement to support Lesotho's medium-term structural adjustment program, and commend the authorities for embarking on the program. The arrangement has taken a long time to construct: it was already being discussed during the 1986 Article IV consultations. The more recent Article IV consultation in February 1987 further underlined the considerable weaknesses in the economy and the hard task of promoting growth in the context of a difficult external environment. I therefore welcome the conclusion of the discussions for this structural adjustment arrangement.

As the staff paper clearly shows, Lesotho's geographic situation and economic environment make economic management particularly difficult. The narrow production base makes the economy heavily dependent on workers' remittances, with exports amounting to only 10 percent of imports, and the scope for independent monetary and exchange rate policies is extremely limited. It is, therefore, particularly important that those tools that are available to the authorities are used as efficiently as possible. As the structural adjustment arrangement is intended to facilitate such use, it is particularly important that the policies supported by the arrangement are implemented in a timely and comprehensive manner.

I attach particular importance to an improvement in the fiscal position and to improvements in the budgetary and planning process. This is correctly deemed central to the objectives of the program supported by the structural adjustment arrangement, and the programmed reduction in the fiscal deficit in the coming year is substantial. Lesotho's budgetary management has not always been of the highest quality; in particular, current expenditure has not always seemed to be under full control. In this respect, I would be interested in any elaboration of the reference in the staff paper to recent action taken by the authorities to improve planning capacity. I welcome the review of the civil service being undertaken in consultation with the World Bank, and would expect that this will identify areas for streamlining. The authorities have set an ambitious target of restricting civil service pay increases to increases in the GDP deflator, but this is necessary to maintain a tight fiscal policy, and I hope that any pressures for pay increases--to retain the skilled members of the civil service--could be accommodated by efficiency improvements.

I welcome the restructuring of income and company taxes. The other revenue-producing measures for 1988 seem appropriate, particularly the increase in fees charged for utilities and other public services with a view to ending budgetary support for recurrent spending in these sectors over the next few years. However, most of the revenue measures this year will be offset by the income tax abatements designed to offset the fiscal drag; hence, the bulk of the fiscal adjustment will have to come from revenue restraint. Under the program, a major source of revenue will be the income tax on miners' remittances, although the staff paper notes that this tax is unlikely to be implemented in the first year of the program. There must be a risk, however, that such a tax may cause remittances to dry up, and I would welcome the staff's assessment of those risks, and of proposals to reduce them. Beyond this, as the paper points out, miners' remittances have a high elasticity with respect to mine employment and wage levels in South Africa, and the future prospects for this employment are uncertain. Given this uncertainty, it might have been useful to have more than one alternative balance of payments scenario, focusing particularly on the change in exogenous variables, such as remittances, in order to assess the likelihood that the authorities may need to implement further adjustment measures to keep the program on track.

I support the proposed structural measures to promote growth in agriculture and manufacturing. Development of these sectors will be essential if Lesotho is to reduce its present heavy dependence on remittances. The measures designed to achieve optimal levels are appropriate, and might serve as an example elsewhere. The incentives for private investment and the introduction of the export financing scheme should both enhance export volumes, but again, the benefits of these incentives may well take some time to be realized. And the extension of those schemes, while potentially helpful, requires careful analysis of the costs and benefits involved, to avoid giving windfall gains to enterprises which may not contribute very much to the economy.

I welcome the proposed land tenure changes which should stimulate loans to the agricultural sector. However, there seems to be a risk that despite the export financing scheme, and the issuing of commercial paper, difficulties may remain in financing domestic productive activity. The use of a wide range of financial instruments to maintain competitiveness, and the change in interest rates, are welcome and necessary moves. The Government is right not to guarantee any new nonconcessional external loans, given the precarious external position and the high fiscal cost of the policies already under way to diversify exports and to promote import substitution.

While the measure supported by the structural adjustment arrangement should move the economy in the right direction, Lesotho's balance of payments prospects will remain poor, even on the more optimistic scenario shown in Table 6 of the staff paper. An improvement on the current account is expected only through an upturn in external official flows. This should not be seen as a precedent for other arrangements under the structural adjustment facility and, indeed, the staff scenarios invite questions as to whether the pace of adjustment is sufficiently fast. I note from Mr. Hassan's statement that Lesotho looks forward to the conversion of the present arrangement into an enhanced structural adjustment arrangement in due course; while Lesotho certainly stands to benefit from such an arrangement and while not seeking to underplay the ambitious scope of the measures being implemented under the current structural adjustment arrangement, any conversion would have to be accompanied by a strengthening of the adjustment process.

Mr. Saha made the following statement:

I welcome the authorities' commitment to addressing the economic and financial problems facing their country in the context of a comprehensive medium-term framework. The macroeconomic and structural adjustment policies as detailed in the policy framework paper are well designed, and the measures envisaged to achieve the program targets are broadly appropriate. However, some of the targets seem somewhat ambitious.

Skilled personnel and adequate capital inflows are prerequisites for the success of the program, and I welcome the emphasis being placed on training. Moreover, the sensitivity of the balance of payments projections to some key assumptions highlights the scarcity of long-term capital inflows, which could make it difficult to achieve some of the targets.

Agriculture and industry are among priority sectors to be developed so as to expand the relatively low level of output and to increase employment opportunities. In this connection, policies contained in the program for 1988/89 and described on pages 14 and 16 of the staff paper are appropriate. In particular, infrastructural support and the economic and financial incentives seem well designed to achieve the objectives set for the productive sector.

Fiscal policy remains a key element in Lesotho's adjustment process. While I generally support actions aimed at improving the budget performance by strengthening the Government's planning and budgeting capacity, broadening the tax base, and restraining expenditure, the budget targets for 1988/89 appear ambitious. These improvements rely heavily on receipts from the South African Customs Union and the projected increase in revenue from the introduction of a tax on migrant miners' incomes. Both of these elements are beyond the authorities' control. The substantial increase in the tax on manufacturing--from 37.5 percent to a unified rate of 45 percent--might discourage investment and thus reduce revenue from this source in the long run. And while a tight fiscal stance is needed, the Government must make efforts to attract and retain skilled workers. Capital expenditure, on the other hand, should reflect the priorities of the country.

The measures envisaged in the program will reduce the dependence of public enterprises on the central government budget and will also strengthen the public sector. While recurrent costs of the public enterprise should be passed on to consumers, exceptions should be made in favor of poorer groups for basic needs such as electricity and water. I wonder whether compensatory measures have been put in place, or are contemplated, to protect the poorer segments of the population.

The measures envisaged under the program for the external sector are appropriate in view of Lesotho's particular situation, and I encourage the authorities to give priority to developing export-oriented and import-substituting industries, attracting migrant workers' savings, and following a prudent external borrowing policy.

In sum, the authorities have demonstrated their willingness to address their economic problems and challenges by taking steps to implement a comprehensive structural adjustment program. But given the degree of uncertainties in the region, the threat of drought, and other unfavorable external factors, the task will be difficult and will require the full support of the international community--particularly the Fund and the World Bank. I support the proposed decision.

Mrs. Walker made the following statement:

At the last Board discussion of Lesotho's economy, I expressed concern over the delay in adopting the adjustment program which the authorities had developed to address the problems facing the economy. We welcome the fact that the authorities are now ready to move ahead with this program. We do, however, have concerns about the staff's assessment of Lesotho's protracted balance of payments need, which we noted at the time of the discussion on the Article IV consultation report, as well as concerns over the degree of rigor that the program entails.

First, regarding evidence of the protracted payments problem, we are disappointed with what we consider to be an inadequate case made in the staff report that Lesotho has a protracted balance of payments problem, and therefore qualifies for a structural adjustment arrangement. While there is clearly a balance of payments need--as evidenced by the current account deficits of recent years--and for a comprehensive macroeconomic and structural reform program, it is not clear to us where the staff finds persuasive evidence of a protracted balance of payments problem. A protracted payments problem is a more demanding test than a general balance of payments need.

We recognize that Lesotho's is not a clear-cut case. However, Lesotho had faced a relatively positive overall balance of payments position over the past several years, with deficits arising only recently, in 1986/87. Furthermore, the base case projections show an overall balance of payments surplus beginning next year and continuing throughout the medium term, as well as a reserve buildup.

We looked in the staff paper for a thorough and precise explanation of why the staff concluded that Lesotho has a protracted payments problem. We recognize that the Board has not clearly defined the meaning of a "protracted payments problem" and that while guidance in this direction can be taken from the Managing Director's summing up on the discussion on the structural adjustment facility, a judgment will need to be made by management on a case-by-case basis. We believe, however, that the case for Lesotho was not made as clearly as it could have been, despite our questions in this regard during last February's Article IV consultation discussion.

We believe that in the future requests for arrangements under the structural adjustment facility or enhanced structural adjustment facility should contain a clearly made case for a protracted payments problem. Without that clarity we may not be able to support a particular loan request. We do not think it is fair to other countries eligible for such arrangements that clearly do have protracted payments problems to treat this criterion lightly. In our view, one of the responsibilities of the Exchange and Trade Relations Department is to make sure that there is a consistent and uniform application of these criteria, and we look forward to a response from the staff on our more general concerns in this area.

We welcome the authorities' intention to pursue a comprehensive program that will use available tools to address some of the weaknesses and vulnerabilities of the economy. We do recognize the difficulties of implementing economic reform due to the constraints on economic policy. There are some important measures included in the program, particularly on the fiscal front, and the targets of the economic program outlined in the policy framework paper are clearly presented. It is, however, less clear how the Government will achieve these targets and in what specific time frame.

We find the pace of reforms slow in some key areas. Certainly, it is difficult to overload the administrative capacity of small developing countries with a number of structural and other reforms at one time, but we found the timing of some of the benchmarks to be exceedingly slow. For example, we wondered why it would take until March 1989 to establish even the guidelines for creation of a parastatal evaluation unit--given that this was a recommendation from the recently completed World Bank review of the operations of the major public enterprises. In addition, we would have thought that more specific action on this sector could have appropriately been part of the structural adjustment arrangement for the first year. That is particularly critical in light of the deterioration in the finances of some public enterprises and the resultant heavy burden that they have placed on the budget.

We do welcome the provision for adjustments in charges and other utility tariffs, although the staff paper did not include any details as to the future timing of adjustments beyond those implemented thus far in 1988/89. In addition, we welcome the authorities' intention to pursue an active divestment policy during the program period. This area could also have been included more specifically in the first year of the program.

The measures that will be taken to reduce the deficit during this fiscal year are critical to the success of the program. Given the pressing problem of the civil service, and its drain on the budget, we were somewhat puzzled as to why there would be such a delay in drawing up the terms of reference for a study of the civil service. In the meantime, the maintenance of low increases in the wage and salary bill, and measures to restrain the growth of the civil service, will make important contributions to the reduction of the budget deficit.

Clearly, the reduction in current expenditures will be an essential component of the fiscal reduction package. The enactment of a sound public sector investment program will also be important, and we would urge a quicker movement of the public sector away from investment together with a faster increase in private sector investment in the economy. In any event, the focus should be on providing market-oriented incentives for increasing private sector involvement. An improvement in the budgetary process will also be important in order to enable the authorities to gain more control over the process itself and over underlying expenditures. Furthermore, rationalization of expenditures to ensure that resources are being used efficiently will play an important role in improving the fiscal situation. On the other hand, the planned revenue-raising measures should be implemented, especially as revenue sources need to be more diversified.

It is imperative that the industrial and agricultural sectors are expanded and diversified, and we welcome the inclusion of related policies in the program. Diversification of exports to lessen reliance on migrant remittances and on imports is also a key ingredient in improving the structure of Lesotho's economic base. Additional attention will need to be given to future measures in this area in addition to the established industrial policy. In this regard, the establishment of the Board of Trustees to oversee investment of migrant workers' remittances will be useful, although it is not scheduled for introduction until March 1989.

Movement in the interest rate structure should help to discourage capital flight, mobilize domestic savings, and channel more financial resources into domestic productive investments. Interest rates should be kept under review and further changes effected if necessary to achieve these goals. A credit policy designed to move substantial financial resources into the productive sector would be useful.

My comments on the protracted balance of payments problem are not evidence of a lack of support for Lesotho's economic adjustment efforts. We believe that the authorities should be commended for adopting a comprehensive economic adjustment

> program, particularly in light of the constraints on their situation, and we urge them to implement the program fully.

Mr. Dai said that he generally agreed with the staff appraisal, and with the summing up of the Committee of the Whole of the World Bank on Lesotho's policy framework paper.

In a small inland developing country like Lesotho with a limited resource base, very low agricultural productivity, and heavy dependence on imports and on one neighboring country, the economy was highly vulnerable to exogenous factors, Mr. Dai remarked. The staff had correctly noted that the task of adjustment and structural reform would consequently be more difficult, and would take a longer time to complete, than in other cases. The success of Lesotho's program required implementation of correct policies and steadfast determination by the authorities, and also substantial assistance from the international community. The proposed structural adjustment arrangement, in collaboration with the assistance of the World Bank, would constitute important international support for the structural reform and development of Lesotho's economy.

In general, the thrust and the framework of the program were aimed in the right direction, Mr. Dai considered. The program correctly placed considerable emphasis on the promotion of the agricultural and industrial sectors where potential lay for expanding production and employment. Increasing and diversifying exports constituted another area of emphasis. Major capital investment by the Government in infrastructural facilities was necessary to support private economic activity and to provide a good investment environment, especially in the initial stages of the program. Under an open trading policy it was appropriate to adjust by importing more capital and intermediate goods for restructuring the economy and enhancing productivity, cutting imports of consumer goods, and attracting more external aid and foreign investment.

Implementation of the program would greatly help to strengthen productivity and to provide a better foundation for achieving a viable balance of payments position in the long run, Mr. Dai concluded. He supported the authorities' efforts in their economic reform and construction, and approved the proposed decision.

Mr. Fuleihan made the following statement:

> The deterioration in Lesotho's economic situation for the past few years has been caused by the decline in workers' remittances, a stagnation in the SACU nominal receipts, and unfavorable weather conditions. The situation has been further exacerbated by institutional weaknesses with respect to policy formulation and implementation, particularly within the budgetary process.

It is encouraging to note that the authorities have recognized the difficulties facing Lesotho's economy and have, in an effort to pre-empt serious future economic dislocations, embarked on a medium-term adjustment program. This process will require sustained efforts for a considerable period of time. Thus Lesotho may have to endure external difficulties in the years ahead.

In light of this prospect, the fiscal targets, along with the balance of payments outlook, may be somewhat optimistic. The optimism is based on the assumption that remittances and customs receipts will not experience adverse shocks, but both have traditionally been volatile. Moreover, the political environment and weather conditions may also greatly affect the program. This highlights the need for the vigorous implementation of the program. Indeed, the importance of this program is that the authorities intend to tackle the economic problems within an overall, consistent, macroeconomic framework.

Turning now to the details of the program, the planned land tenure arrangements and the adoption of realistic minimum pricing policies are appropriate. Both measures will help the agricultural sector to realize its potential, and the former will also enhance private domestic investment. While I support the planned investment incentives in the industrial sector, careful attention to their fiscal implications will be needed.

Fiscal policy will clearly have to bear the brunt of the adjustment process. Therefore, an improvement in budgetary management is of the utmost importance. As the authorities will have to draw a delicate balance between fiscal contraction and the growth objective, a close scrutiny of public sector investment will be needed. It is noteworthy that the authorities are aware of this and are requesting World Bank assistance. Furthermore, the setting up of the parastatal evaluation unit with a view to ensuring cost recovery is warranted. I also welcome the rationalization of the civil service and the pursuit of a divestiture program.

Although the authorities have only limited influence on monetary, exchange rate, and trade policies, there is a clear role for appropriate financial policies. The improvement in the financial intermediation process of commercial banks is essential if domestic investment is to be enhanced. The proposed export financing scheme, along with the issuance of corporate commercial paper, will help private sector expansion. I also welcome the continued issuance of freely transferable bonds in small denominations and with appropriate maturities. This will increase both domestic savings and facilitate the repatriation of migrant earnings.

To conclude, the authorities are embarking on a long and difficult process. As the proposed fiscal objective seems slightly ambitious, the authorities may need to take further measures to strengthen the adjustment effort. Consistent policies, meticulous planning, and, above all, perseverance are crucial for the success of the program. I support the proposed decision.

Mr. Wenzel made the following statement:

I welcome the conclusion of the discussion between the staff and the authorities, and the latter's resolve to embark on a comprehensive and ambitious adjustment. Their policy intentions go in the right direction and--if successfully implemented--will make an important contribution toward strengthening the external position and restoring economic growth. At the same time, however, I am disappointed at an apparent lack of specifics with regard to the timing of the contemplated measures. I am referring to Table 2 in the policy framework paper. I certainly do not doubt the commitment of the authorities, but a more specific timetable would greatly enhance the credibility of their adjustment effort.

A more serious concern arises with regard to the authorities' capability of implementing the program. Given the gravity of the situation, far-reaching macroeconomic and structural reforms are indeed required--if not overdue. But I recall, from the Article IV consultation discussion in February, the staff's recommendation to strengthen economic and financial management capacity. It appears that sufficient measures in this regard have not yet been taken, and I therefore urge the authorities to make use of technical assistance from the World Bank and the Fund. Moreover, to the extent possible, such measures should be adopted prior to the second annual arrangement.

Let me now turn briefly to the most important policy areas--fiscal and monetary policy. I agree that fiscal adjustment will be crucial for the success of the program. Therefore, I welcome the contemplated significant reduction in the fiscal deficit. Given the likely political and administrative difficulties of increasing revenues, however, I wonder whether--at least at this stage--the intended personal income tax abatements should be delayed or reduced.

I welcome the recent increase in interest rates, an important step toward positive real interest rates. Nonetheless, interest rate policy has to be strengthened further to enhance domestic capital formation and to attract savings from expatriates. Similarly, I am concerned about the envisaged high rate of monetary expansion which could undermine the objective of reducing inflation. I would also encourage the authorities to expedite their efforts to reduce excess liquidity in the domestic banking system.

Finally, it would appear that prior to a possible conversion to an enhanced structural adjustment arrangement, the structural component of the program will have to be specified more clearly, at least with regard to timing. Management capacity also seems to need strengthening in order to reach a viable balance of payments position at the end of the arrangement, and thus to ensure the repayment of possible purchases under the enhanced structural adjustment facility.

The staff representative from the African Department observed that during the course of the previous fiscal year, the authorities had reorganized the Ministry of Planning in order to improve planning and budgeting capacity. In addition, they had completed the first draft of a public sector investment program to which recurrent expenditure would be tied more closely. Those reforms constituted a substantial policy improvement.

It had always been the intention of the Government to secure a more direct contribution from the miners to government revenues, given that miners made substantial use of facilities provided by the Government, the staff representative continued. With that in mind, the authorities had been negotiating with South Africa and the mining companies to extend the income tax to the miners. In order to reduce the risk of a reduction in remittances, however, they had also decided to strengthen the miners' deferred pay fund by amending the relevant legislation so as to enable the Government to pay higher rates of interest through the issuance of government stocks and bonds. Miners would in that case have an incentive to retain their incomes in Lesotho. Currently, the interest paid on miners' deposits was between 4 percent and 5 percent, compared with the return on government stock of about 12-14 percent.

In the course of the mission, the staff had developed several balance of payments scenarios, but believed that the program objective could best be discussed by displaying a baseline scenario--the optimistic scenario--together with the sensitivity analysis that presented a less optimistic scenario based on a flow of migrant remittances that was constant in nominal terms, the staff representative noted. The latter eventuality would have a disastrous effect on the balance of payments and on the economy as a whole.

While the staff agreed that the budget target was by no means an easy one, it was both attainable and necessary if the objectives of the program were to be achieved, the staff representative considered.

One Director had observed that a larger increase in the share of private sector investment in total investment would have been appropriate, the staff representative from the African Department recalled. A number of projects were now in the pipeline that would only begin to bear fruit toward the second and especially third years of the program. However, it was possible that the impact would be felt somewhat earlier, and in that case, the staff was being somewhat conservative in its projections.

The staff representative from the Exchange and Trade Relations Department commented that during the 1986 Article IV consultation, consideration had already been given to a possible package of comprehensive structural adjustment measures supported by a structural adjustment arrangement. That consideration was echoed in the second paragraph of the 1987 Article IV consultation discussed in the Board earlier in 1988. During both consultations, it was clearly understood that there was an underlying deteriorating trend in the economy, and that medium-term prospects would be endangered if present policy weaknesses were allowed to continue. The staff report for the 1987 Article IV consultation had quite specifically concluded that on the basis of an analysis of possible medium-term scenarios, Lesotho was an appropriate case for an arrangement under the structural adjustment facility.

The Chairman's summing up of the 1987 Article IV consultation with Lesotho (EBM/87/17, 2/17/87) had noted that Directors agreed with the thrust of the staff appraisal, the staff representative recalled. The summing up had also said that "Directors noted that the dependency of Lesotho on remittances from its workers in South African mines and were particularly concerned that Lesotho's medium-term external payments position was projected to remain difficult." In addition, the summing up had also emphasized the kinds of comprehensive structural policy measures that would be needed to address that problem. Finally, the summing up had concluded that "Directors acknowledged that the impact of these measures would be felt in the long term and emphasized that this only reinforced the importance of the early implementation." Hence, it was fair to conclude that there was a general sentiment that Lesotho was a country where structural problems needed to be addressed through an arrangement under the structural adjustment facility.

In addition, discussions of the structural adjustment facility itself seemed to indicate that countries like Lesotho would become prime candidates for assistance under the facility, the staff representative continued. The summing up on the structural adjustment facility at EBM/87/93 (6/19/87) said "clearly, while the existence of protracted balance of payments problems should remain a criterion for use of the facility, most Directors emphasized that a priori a low-income country satisfied the criterion." All in all, there was considerable background to suggest that Lesotho would be an appropriate case for an arrangement under the structural adjustment facility.

The staff paper before the Board brought the discussion of criterion up to date with regard to Lesotho's case in particular, the staff representative remarked. It showed that there had been a substantial deterioration in the current account, the balance of payments, and the gross official reserve position. In it, the staff noted that except for

1984/85, the external current account had been in deficit, and that during the past three years those current account gaps had been substantially larger than during the year preceding. At the same time, there had been a very steep rise in Lesotho's external debt, and the reserve position was dismally low--too low to allow any room for maneuver. Those were the basic difficulties indicated in Section 2 of the staff paper.

Section 3 of the paper began with a retrospective analysis of the external situation, the staff representative observed, noting that "the country's medium- and long-term prospects are not favorable unless prompt stabilization as well as structural measures are taken promptly." The section then continued with an analysis of the continuing balance of payments problem. On pages 12 and 13, the staff had explored the high vulnerability of that balance of payments, related to the narrow export base and the vulnerability of large amounts of migrant remittances.

Despite the staff's conclusions, it was possible that further guidance from the Board would be helpful, the staff representative from the Exchange and Trade Relations Department commented. Perhaps Directors would prefer the staff to isolate the factors that in a particular case indicated a protracted balance of payments difficulty. That contrasted with the approach adopted in the paper currently before the Board, which underlined the structural fragility of the balance of payments, the specific trends that had caused concern since 1986, and the Board summings up for the Article IV consultation that had directly pointed to the need for an arrangement under the structural adjustment facility. Similar problems of presentation had occurred in a number of structural adjustment arrangements before the Board, and hence some guidance from the Board might be useful.

Mr. Hassan said that on the question of a protracted balance of payments problem, it was important to give due consideration particularly for a landlocked low-income country like Lesotho to the structure of an economy--its vulnerability to exogenous factors, and room for maneuver that might allow the authorities to pursue an independent economic policy. Those considerations were relevant in the case of Lesotho. Its balance of payments completely depended on workers' remittances and excerpts from the Southern Africa Custom Union, which were fully controlled by the policies of South Africa. Lesotho's membership in the Rand Monetary Union limited the scope for any independent exchange rate or monetary policies.

In such circumstances, the accumulation of a minimum level of reserves became a necessity, Mr. Hassan considered. Hence, the level of reserves did not necessarily reflect the strength of the underlying balance of payments position, rather it indicated the cautious and protective nature of the authorities' policies. Accordingly, it would not be appropriate to conclude that Lesotho did not have a protracted balance of payments problem because it had some level of reserves.

In view of the limited availability of monetary and exchange rate policies, fiscal policy would understandably bear the brunt of adjustment, Mr. Hassan remarked. However, as the Executive Director of the World Bank had noted, the fiscal target set under the program might be too ambitious. That was particularly true given the budget dependency on SACU revenues, which had proved unstable and influenced by the policies of South Africa. Hence, while reaffirming the authorities' commitment to the program, future assessment of Lesotho's performance under the structural adjustment arrangement would need to pay due attention to those factors. That was particularly important because Lesotho's access to the enhanced structural adjustment facility would depend on such an assessment.

An appropriate pace of adjustment depended on the country's capacity to adjust, which itself related to the structure of the economy and its level of development, Mr. Hassan observed. An appropriate pace of adjustment for a diversified and well-developed economy might not be feasible for a country such as Lesotho. Pushing the pace of adjustment beyond the limits of feasibility might be counterproductive. That should not in any way be interpreted as lack of commitment on the part of the authorities, because they fully intended to implement the program with the utmost vigor.

The Executive Board then took the following decision:

1. The Government of Lesotho has requested a three-year structural adjustment arrangement, and the first annual arrangement thereunder, under the structural adjustment facility.

2. The Fund approves the arrangements set forth in EBS/88/107, Supplement 1.

Decision No. 8914 -(88/102), adopted
June 29, 1988

3. ST. LUCIA - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with St. Lucia (SM/88/125, 6/7/88). They also had before them a background paper on recent economic developments in St. Lucia (SM/88/127, 6/9/88).

Mr. Massé made the following statement:

The staff analysis corresponds very closely to the views of the authorities and results in recommendations with which the St. Lucian authorities are in general agreement.

During the last year and a half, the St. Lucian economy has gone through a difficult period, followed by a recovery. During 1987, GDP grew in real terms by only about 2 percent as a result of a drought in agriculture and a slowdown in tourism. However, during the first part of 1988, economic indices indicate a return to the 5 percent real growth rate of previous years as agricultural production came out of its weather-induced, depressed state and as a result of a fast increasing pace of construction activity. Prices rose at a rate of almost 7 percent in 1987 as a consequence of the scarcity created by the reduced agricultural production, but prices should now stabilize following the resurgence in agricultural output. Tourism stagnated during most of 1987, but improved considerably during the last months of the year. The recovery continued in 1988, partly as a result of exchange rate developments which increased the attractiveness of the island as a tourist destination for European visitors. Investors have now shown interest in increasing the hotel capacity on the island and this should lead to major investments in that field. Construction has been showing remarkable growth in the last year or so and that sector is expected to continue its major contribution to growth in the economy. Balance of payments developments in 1987 were mixed, but on the whole turned out favorably. Exports suffered from a significant decline in banana sales while increased investment by the public and private sectors resulted in a large increase in imports. However, capital inflows from both the private and the official sectors more than made up for the current account deficit and led to an overall balance of payments surplus in excess of 4 percent of GDP. Public sector finances improved markedly over the last 18 months as the rate of growth of public sector expenditures was much lower than the growth rate of revenues and in 1987 the public sector overall balance had a surplus equivalent to more than 2 percent of GDP.

While welcoming these very positive trends, the authorities in St. Lucia intend to continue to monitor the economy closely and to intervene whenever necessary to keep it on a high growth path and in a healthy financial state. In particular, they intend to watch closely public sector expenditures and to keep wage rates in that sector within a ceiling of 7-8 percent for the next three years--i.e., an average of about 2½ percent a year.

The St. Lucian authorities base their hopes for continuing economic development on increasing productivity and performance in agriculture with diversification into vegetables and food items other than bananas. The Government is encouraging investment in the manufacturing sector by constructing factory shells for rental to foreign investors, and in tourism, by promoting new hotel construction by the private sector. The Government also uses its own investment program to stimulate the economy and to provide needed infrastructure support.

The Government has recently introduced a number of tax reforms to improve the coverage and structure of the tax system. These measures have included a 5 percent banana export tax and the immediate reduction of the tax on the sale of foreign exchange as a first step toward its elimination. A 1 percent surcharge on imports was put into place at the beginning of this year together with a restructuration of a number of indirect taxes. The effect of these various tax measures is expected to be revenue neutral. Because of the increase in the Government's investment program, the overall balance of the public sector for 1988 should show a deficit of about 4 percent of GDP. However, given the level of net foreign financing already committed, the Government's net domestic position would improve significantly.

The external debt has oscillated between 17 and 22 percent of GDP between 1983 and the present, with the level at the end of 1987 being equivalent to about 19 percent of GDP. However, most of the loans made to St. Lucia have been made at concessionary interest rates and, in consequence, debt service payments are not expected to exceed 4 percent of exports of goods and services over the medium or the long term, and would not exceed 7 percent of public sector revenues at their highest point. By the end of 1987, some arrears on external debt service obligations had been accumulated. However, these total less than $1 million and the authorities intend to liquidate all arrears by the end of the current fiscal year.

In conclusion, the authorities intend to press on with the implementation of the improved economic measures that have been put into place over the last few years, and will continue to exert all their efforts to produce a high rate of growth while keeping inflation in check and the balance of payments under control.

Mr. Barr made the following statement:

The staff report highlights the strong underlying growth of St. Lucia's economy associated with the improvement in public finances--a growth which continued last year despite the effects of the drought. I have no difficulty in endorsing the staff appraisal, and I support the proposal to move St. Lucia onto the bicyclic consultation procedure.

Given the nature of the exchange rate mechanism in St. Lucia, the main policy instrument will continue to be fiscal management. Notable progress has been made in improving the fiscal balance over recent years and I can particularly commend the budget performance in 1987. However, I was disappointed to see that the authorities did not correct their external arrears last year, given the estimated fiscal surplus. Large net external financing is expected in 1988, and I welcome the budgetary provision that has been made to eliminate these arrears this year--a necessary step for maintaining foreign confidence and promoting external aid flows.

A strong fiscal position is central to continued growth with low inflation. I welcome the increase in tax revenues in 1987 and the restructuring of the tax system earlier this year. I agree with the staff that continued restraint on the fiscal side is required--in particular in setting government wage increases and in controlling locally financed capital expenditure.

The authorities' intention to reduce domestic debt is commendable. Nonetheless, I find it surprising that despite the strong liquidity position of the commercial banks, more savings are not being channeled into productive investments. Table 31 of the background paper illustrates that although deposit rates have fallen over the last few years, lending rates have not fallen to the same extent. In light of the resumption of agricultural growth following the drought and the increase in private savings expected from the reduction in the stock of treasury bills, could the staff comment on any measures that are being pursued to channel these resources into productive activity?

I welcome the structural measures being undertaken to enhance export diversification and import substitution. I assume that the 5 percent export tax on bananas will be used to finance general export diversification rather than investments in a specific sector. In this context, given the high level of tourist receipts and the capacity constraint in the tourist industry at present, could the staff comment on the extent--if any--to which domestic financing for this sector is provided for in the Public Sector Investment Plan to complement the major foreign investment mentioned in Mr. Massé's statement.

The expansion of St. Lucia's reserves at the Eastern Caribbean Central Bank is prudent, and I agree with the staff that although net capital inflows are sufficient to finance the projected current account deficits over the medium term, it would be wise for the authorities to continue to strengthen the reserve position to cushion against possible future shocks. Although the external outlook looks favorable, it might have been helpful if the staff could have provided more regional analysis on, for example, the cost competitiveness of St. Lucia vis-à-vis other Caribbean states, particularly in relation to tourism. Table 45 of the background paper shows that St. Lucia's real exchange rate has appreciated against some other Caribbean states, but it was not clear whether real exchange rate movements in the region had particularly adverse effects for individual islands.

I commend the authorities on their improved fiscal management and urge the continuation of fiscal restraint to promote strong medium-term growth. Although the outlook for St. Lucia is generally favorable, balance of payments viability relies on continued external flows, and the authorities should be wary of relaxing appropriate policy measures.

Mr. Legg made the following statement:

I am in broad agreement with the staff appraisal. In common with a number of the smaller members of this chair's constituency, St. Lucia faces a number of particular constraints associated with its status as a small developing island economy. Notably, these include a relatively narrow economic base and limited infrastructure, difficulties in accessing major external markets, heavy reliance on imports, especially imported capital, and a generally constrained set of policy options. Against this background, and notwithstanding the setbacks experienced in 1987, the performance of the St. Lucian economy in recent years has been particularly encouraging, with its track record of strong growth, relatively low inflation, and stability in the external accounts.

The thrust of Directors' comments at the time of the 1987 Article IV consultation with St. Lucia was the need to consolidate this track record through the application of prudent fiscal and wages policies. In the event, factors outside the authorities' control, specifically drought and some slowdown in tourism, interrupted this process, resulting in a sharp fall in the rate of growth and a significant acceleration in price pressures. We welcome the prospects for a good recovery on both these fronts for 1988. Indeed, the authorities should be commended for weathering the storm with their commitment to appropriate financial policies and their longer-term development strategy intact.

The authorities' declared aims of diversification into nontraditional agricultural products for export and import substitution, together with an expansion of capacity in the tourism sector and encouragement of export-oriented enclave manufacturing, seem eminently sensible, particularly given the longer term uncertainties pertaining to the traditional U.K. export market for St. Lucia's banana industry. I would be interested in the staff's assessment of the feasibility of the authorities' banana production target of 120,000 metric tons annually. Nevertheless, this strategy is not without risks, which will need to be monitored.

First, the public investment program envisaged for 1988-89 is clearly ambitious. I note the staff assessment that the medium-term implications of this program for the current account are "sustainable," although the program is expected to be associated with a sizable increase in the underlying current account deficit. The greatest portion of this investment will be financed by external funds already committed. The financial position of St. Lucia's public sector enterprises, which will apparently undertake most of this investment, has also improved significantly in recent years. Nevertheless, against the background of the significant buildup in the ratio of external debt to GDP envisaged over the medium term, and in light of the comments made in the recent World Bank report on St. Lucia, we urge the authorities to strengthen their project evaluation and assessment procedures with an eye to the long-term return on this investment.

Second, there is a more general concern relating to absorptive capacity constraints. It is, of course, encouraging that inflationary pressures are expected to ease in 1988, even if they do not fully return to the low pre-1987 levels. However, the continuing rapid pace of domestic activity in the construction sector will need to be closely monitored, as will the pattern of domestic credit growth. In this regard, we note the emerging evidence of skilled labor shortages referred to in the staff papers, and the authorities' own concerns at the nonproductive nature of much of the recent growth in domestic credit by commercial banks. The staff also referred to the absorptive capacity constraints, and I would be grateful for an elaboration of their views on that issue.

The authorities' policy options are limited by the lack of any independent control over monetary policy or the exchange rate. The macroeconomic policy must therefore continue to emphasize prudent fiscal and wages policies designed to maintain international competitiveness and to make room for the planned investment. In this context, therefore, the authorities' commitment to further current expenditure restraint in 1988, and the resulting improvement in public sector savings, are clearly important and should be commended, as should the recent efforts to broaden the tax base significantly. The authorities clearly also recognize the importance of wage restraint, and we welcome their intention to restrict public sector wages growth over the next three years to a ceiling of 8 percent.

Finally, in common with the previous speaker, this chair is disappointed that more effort had not been made by the authorities during the past year to liquidate St. Lucia's outstanding arrears, particularly in view of the overall external surplus. Naturally, we welcome the authorities' intention to repay these arrears during the current financial year. We have no difficulties with the proposed 24-month Article IV consultation cycle for St. Lucia.

Mr. Hogeweg noted that there were no important differences of opinion between the staff and the authorities of St. Lucia on the analysis of the economy, although he had a few points on which he requested clarification. First, while the external public sector arrears were small, they were all incurred in the years 1984, 1985, and 1987--years in which the consolidated public sector had been in surplus. It was projected that the arrears would be eliminated in 1988, the year in which large public sector investment projects would lead to a sizable deficit in the public sector account. He wondered whether the staff could elaborate on the nature of those arrears.

Second, there were some questions concerning the staff's description of monetary developments, Mr. Hogeweg continued. For instance, on page 4 of the staff report the staff had noted that private sector deposits with commercial banks had increased at a faster rate than domestic credit, making possible a large increase in the banks' net reserve position. That did not, in his view, indicate the correct line of causality. Not surprisingly, the next paragraph indicated that the overall external balance had consistently shown surpluses since 1983. That was where the deposits with the domestic banks had evidently originated. It would be clearer to say that since capital inflows had exceeded the current account deficit, monetary expansion had been larger than accounted for by net domestic credit expansion. The counterpart of that overall nonbank balance of payments surplus had been an increase in both the banks' foreign assets and in their deposits with the common central bank--that was to say, higher bank liquidity.

That, of course, left the question of why exactly capital inflows, largely on concessional terms, had consistently exceeded the current account requirement, Mr. Hogeweg remarked. The inflows had evidently resulted in the easing of monetary conditions, which might, in turn, boost domestic credit. Something seemed to be wrong in a process whereby the proceeds of concessional external debt were now seeking a productive investment, and he would appreciate staff comments on the issue.

Mr. Almeida remarked that his chair generally agreed with the staff analysis and appraisal. Over the past five years, there had been considerable progress toward reducing macroeconomic structural imbalances in St. Lucia, and the balance of payments prospects for the near term appeared favorable. However, the current account remained fragile in the short run, and a small amount of external arrears still remained at the end of the fiscal year.

He supported the Government strategy of reorienting economic policies toward domestic savings, together with the expansion of those activities--particularly agricultural and tourism--which had improved the balance and the prospects of the economy in the long run, Mr. Almeida continued. The authorities should be aware, however, that public sector investments were not appropriately integrated into the current and capital budgets; hence, project monitoring procedures had to be streamlined in order to avoid cost overruns and slippage in implementation.

He agreed with the authorities' strategy regarding the banana sector, a strategy which aimed at stabilizing production as excess production in the past had led to waste for lack of warehouse capacity, particularly during the winter months, Mr. Almeida commented. Much could clearly be done to improve fruit quality and productivity, as production costs were still higher than those of most free market competitors, and the authorities were correctly paying more attention to diversification of exports into nontraditional markets. The authorities' emphasis on promoting increases in national savings was well directed, and he was pleased to see that public sector savings had continued to increase in 1988 for the sixth year in a row, and that prices had been kept under control.

The authorities had maintained a basically sound fiscal position during the past few years, but there had been some deterioration in the overall position of the public sector in 1988, Mr. Almeida considered. He urged the authorities to continue their efforts to control expenditures, as the current level of taxation was already too high at 40 percent of GDP. He commended the authorities' strict incomes policies for wages and salaries in the public sector.

He also commended the work to strengthen private savings, Mr. Almeida concluded. He viewed the prevailing competitive interest rates as a necessary condition for attracting and maintaining savings in a domestic and financial market. In general, St. Lucia's economic performance has been satisfactory, and policies were in place to sustain the economic transformation of the country.

Mrs. Walker made the following statement:

> The economic developments in St. Lucia in 1987 demonstrate the economy's vulnerability to exogenous developments, as the drought reduced the growth rate in agriculture and caused sharp increase in food prices. As a result, the current account deficit widened. In addition, the improvement in the overall public sector finances was due to delays in the wage agreement and in the implementation of certain projects.
>
> The outlook for 1988 shows an improved rate of growth owing to a return to a more normal level of agricultural production. However, the public sector financial position is projected to shift into a deficit of 4 percent of GDP, although this deficit can be financed without much strain on the balance of payments even while the remaining arrears are eliminated. We would, however, urge the authorities to hold firm on wage increase negotiations and not go beyond the 8 percent level. In addition, it appears that the projected significant increase in the Government's capital outlays could place a strain on the country's capacity to implement investment projects. Here I note the World Bank's concern about the adequacy of planning in the public sector investment program and about the country's institutional capacity to implement and monitor projects. In light

of the fact that expenditure in the capital budget approved last March appears to be above the amounts included in the Public Sector Investment Plan discussed with the World Bank, we would urge the authorities to act in the direction of the World Bank's suggestions so as to integrate the current and capital budgets better, and to improve the assessment of the recurring project costs. Further, it appears appropriate that the authorities should not begin projects until sources of financing can be identified.

We welcome the authorities' efforts to improve the efficiency of the tax system and revenue potential, and would appreciate staff comment on the effects of the reform in this case.

We remain convinced, as we have said in past Article IV discussions, that the development strategy of the Government of St. Lucia remains appropriate in that it is based on active private sector involvement. The authorities continue to emphasize export diversification, as well as some import substitution. In this regard, I welcome the steps taken to diversify agricultural, production and would agree with the plan to sell agricultural products to the tourism sector. In the area of tourism, the overall economic environment will need to remain conducive to foreign investment. The authorities' actions in the banana sector also appear appropriate in light of current market potential.

Finally, I do not believe that a 24-month cycle is the same as a bicyclic cycle, but we do support it in this case.

The staff representative from the Western Hemisphere Department commented that the request of the authorities was for a 24-month cycle rather than for the introduction of the bicyclic procedure. Under the 24-month cycle, there would be a staff visit between consultations, but there would be no report to the Board, as there would be were the bicyclic procedure to be adopted.

The high liquidity position of the banks was explained by the narrowness of the private sector, which was a limiting factor for effective credit demand from the banks, the staff representative continued. The banks insisted, of course, that the risk of the investment be properly covered and that projects be adequately prepared, and that had limited credit more than the level of interest rates. The banks had assured the staff that any viable project would be financed.

The banana tax would indeed be used for sector diversification, the staff representative commented. Past substantial government expenditures on improving roads and ports and other infrastructure had benefited both the banana sector and other agricultural products. Those benefits would continue.

The Government believed that the development of hotels should be undertaken strictly by the private sector, but it was providing infrastructural support through the provision of roads, water, electricity, telephones, and other communications so that the private sector could find a proper environment in which to develop the tourist industry, the staff representative remarked. Clearly, then, there was a relationship between the public sector investment program and tourism, but only to the extent that the program aimed to provide infrastructure for private sector development.

The target of 120,000 tons for the annual banana crop was certainly a realistic target, the staff representative said. The problem, if anything, was that the Government did not wish to have production exceed that level because the U.K. market did not have the capacity to absorb higher volumes of bananas. Figures very close to the level of 120,000 tons had been achieved in past years. Incidentally, one reason for the banana tax of 5 percent was--given the good prices for bananas currently being obtained--to act as a deterrent against the excessive expansion of production.

Financing related to the public sector investment program could help from both the fiscal and the balance of payments points of view, the staff representative considered. The staff believed that the economy was able to absorb the current level of investment, but that it would not be wise to go much beyond that level at present, as technical and human factors would act as constraints.

The external arrears in 1988 were mainly arrears in suppliers' credit, the staff representative explained. An arrears situation had indeed existed for some years. Currently, the arrears were relatively small--on the order of $600,000. In addition, the arrears represented a rotating stock, and none had been outstanding for a long period of time. Hence, the arrears represented some delays in payment rather than any more serious problem, but the authorities intended to correct the situation before the end of the current fiscal year.

It was important to remember the peculiar monetary arrangement in St. Lucia, the staff representative remarked. It shared a common central bank with other East Caribbean islands. Hence, the authorities did not have direct control of their net international reserve, which was held in a pool of resources at the regional central bank. Thus, St. Lucia's level of international reserves was imputed and was not directly under the authorities' control. To the extent that the central bank was gaining reserves as a whole, one would expect that the balance of payments for St. Lucia was in surplus unless the accumulation of arrears exceeded the increase in the imputed share of reserves. Therefore, most of the adjustment took place between the current and the capital accounts. To the extent that there were indeed capital inflows, there could also potentially be capital outflows in the form of capital flight. That would reflect the choice of St. Lucian residents to keep their savings either in the domestic economy or abroad. The increased liquidity of domestic banks reflected decisions to keep savings in local banks rather than abroad, decisions taken despite the rather low rates of interest that the domestic banks were paying. Were that money to go abroad, the adjustment would occur in the current account because those funds would not be available to finance imports.

The Government's tax strategy was to broaden the tax base and simplify the tax structure, the staff representative from the Western Hemisphere Department noted. The authorities wished to reduce the number of taxes and to broaden the tax base. That would make for more buoyant or elastic revenues in relation to the growth in national income.

The staff representative from the World Bank said that as indicated in the World Bank's recent economic report, there was a specific level of investment that could be absorbed in St. Lucia provided that the Government implemented the recommendations on strengthening the planning, execution, and monitoring of the public sector investment program, and introduce the other reforms that would help to integrate the capital inflow into the economy.

Mr. Hogeweg said that he had wondered why the balance of concessional capital inflows appeared to exceed the deficit on the current account. That led to the question of why the capital inflows ended up as bank liquidity essentially seeking productive investment which did not appear to be available--a somewhat strange situation.

The staff representative from the Western Hemisphere Department commented that the concessional capital flows--meaning the loans and grants--were directly related to the public sector investment program. It could well be the case that if, for instance, there were strong exports of tourism and if one looked at that portion of the capital account that represented the loans and the project-related grants, the sum of grants and loans could exceed the current account deficit on a net basis. One would then expect the commercial banks to increase their holdings abroad, either in foreign banks or with the Eastern Caribbean Central Bank. Otherwise there would be capital flight, which had not apparently been the case in St. Lucia.

Mr. Massé said that the authorities had clearly faced some constraints in the amount of possible investment in the private sector; even though interest rates had been very low, entrepreneurs had not emerged as fast as anticipated. Hence, the operative constraint was that of entrepreneurship rather than of available capital. The authorities had therefore considerably increased their own investment program, and had then run into the problem of integrating their capital plans with maintenance consequences for the current account. The authorities now faced the problem of increasing the basic rate of growth when the private sector had reached a human resources constraint and the public sector had reached the planning constraint. The problem was to find investment opportunities with a high enough rate of return still controllable by the personnel available in the public sector. Hence, the Government was attempting to determine the maximum amount of investments that the public sector could implement effectively, and that maximum could perhaps be slightly lower than that attempted in the course of the last public sector investment program.

The external arrears were, in fact, mostly related to trade and were of a revolving nature, and there were no pressures to resolve them quickly, Mr. Massé continued. They had traditionally, in fact, not been considered arrears by the authorities, who had decided to clear them quickly when the Fund mission had indicated that in the Fund's view they could indeed be counted as arrears.

The Acting Chairman made the following summing up:

> Directors expressed general agreement with the staff appraisal. They noted that except for a weather-related setback in 1987, the economy had grown vigorously in the last few years, inflation had remained low, and unemployment appeared to have eased. In addition, the strong growth in exports and tourism and sizable capital inflows had resulted in a marked strengthening of St. Lucia's balance of payments and a substantial buildup in commercial banks' reserves.
>
> Directors welcomed the significant improvement in the public finances since 1983, and this had permitted the Government to reduce its net domestic indebtedness significantly. However, Directors observed that some overdue obligations to foreign creditors incurred several years ago remained at the end of 1987, and urged the authorities to liquidate these arrears, as planned, before the end of the current fiscal year.
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> Directors cautioned against any relaxation of the fiscal stance and urged the authorities to exercise restraint in their current wage negotiations with civil servants so as to consolidate the fiscal gains of recent years. Speakers also indicated the need to integrate the Government's capital and current budgets. In view of the sharp increase in capital outlays planned for the next two years, Directors recommended that projects undertaken by the public sector be appraised carefully in light of the economy's absorptive capacity and assurances of appropriate financing as well as of the viability of the projects and the country's capacity to implement and monitor them effectively. The authorities' declared aims of export diversification and import substitution were welcomed.
>
> While observing that the medium-term outlook for the balance of payments appeared favorable, Directors encouraged the

authorities to continue to monitor exchange rate developments in collaboration with other members of the Eastern Caribbean Central Bank.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/101 (6/27/88) and EBM/88/102 (6/29/88).

4. YUGOSLAVIA - STAND-BY ARRANGEMENT - EFFECTIVE DATE

1. The Fund finds that satisfactory arrangements have been made with respect to Yugoslavia's foreign financing needs in 1988.

2. Accordingly, the stand-by arrangement for Yugoslavia set forth in EBS/88/89, Supplement 4, shall enter into effect on June 28, 1988. (EBS/88/89, Sup. 5)

Decision No. 8915-(88/102), adopted
June 28, 1988

5. ISSUES IN THE DEBT STRATEGY - PUBLICATION

The Executive Board approves the proposal to publish the paper entitled "Issues in the Debt Strategy" (EBS/88/5, 1/13/88), as part of a Fund compendium on debt, as set forth in EBD/88/167 (6/16/88) and Supplement 1 (6/24/88).

Adopted June 27, 1988

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/155 (6/24/88) and EBAP/88/157 (6/27/88) and by Advisors to Executive Directors as set forth in EBAP/88/157 (6/27/88) is approved.

7. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/88/156, Supplement 1 (6/28/88) is approved.

APPROVED: February 3, 1989

LEO VAN HOUTVEN
Secretary