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Minutes of Executive Board Meeting 88/168

4:15 p.m., November 18, 1988

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

Executive Directors	Alternate Executive Directors
	C. Enoch
Dai Q.	
	D. C. Templeman, Temporary
	A. Rieffel, Temporary
J. de Groote	
E. T. El Kogali	P. E. Archibong, Temporary
E. V. Feldman	
	R. Marino, Temporary
	M. B. Chatah, Temporary
M. R. Ghasimi	O. Kabbaj
	K.-H. Kleine, Temporary
J. E. Ismael	E. Kiriwat
	L. E. N. Fernando
A. Kafka	J. Hospedales
	C. L. Haynes, Temporary
	C. V. Santos
	K. Kpetigo, Temporary
	B. R. Fuleihan, Temporary
J. Ovi	
	G. Pineau, Temporary
	G. P. J. Hogeweg
	F. E. R. Alfiler, Temporary
	T. Morita, Temporary
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
S. L. Yeager, Assistant

Also Present

African Department: E. L. Bornemann, Deputy Director; G. E. Gondwe, Deputy Director; K. B. Dillon, J. K. M. Kinyua, T. Van der Willigen. Exchange and Trade Relations Department: A. Basu, E. Brau, B. C. Stuart. Legal Department: P. L. Francotte, A. O. Liuksila, J. K. Oh. Research Department: A. D. Crockett, Deputy Director; R. G. Alter, A. Muttardy, R. Pownall, B. E. Rourke. Western Hemisphere Department: S. T. Beza, Director; J. Ferrán, Deputy Director; L. A. Cardemil, C. M. Loser, E. Decarli, R. A. Elson, H. Ghesquiere, O. Gronlie, J. R. Karlik, G. R. Le Fort, C. I. Medeiros, S. C. de Sosa, S. J. Stephens. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: N. Adachi, M. Pétursson, S. P. Shrestha, J. E. Zeas. Assistants to Executive Directors: J. R. N. Almeida, E. C. Demaestri, S. K. Fayyad, F. El Fiky, S. Guribye, A. Hashim, J. Heywood, C. J. Jarvis, P. Kapetanović, V. K. Malhotra, W. K. Parmena, L. M. Piantini, J.-P. Schoder, G. Serre, Yang J.

1. EXTENSION OF ENLARGED ACCESS POLICY AND ACCESS LIMITS FOR 1989 - PROPOSED DECISION

During the Committee of the Whole on the Ninth General Review of Quotas Meeting 88/11 (11/18/88), the Executive Directors agreed that the proposed decision on the extension of the enlarged access policy and access limits for 1989, which was to be circulated for approval on a lapse of time basis (see SM/88/252, Rev. 1, 11/21/88), should be revised to clarify that the policy would be reviewed in light of the outcome of the Ninth General Review of Quotas, and that that review would take place no later than the date on which the quota increase would become effective.

2. TRINIDAD AND TOBAGO - 1988 ARTICLE IV CONSULTATION; AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered the staff report for the 1988 Article IV consultation with Trinidad and Tobago (SM/88/224, 10/13/88), together with Trinidad and Tobago's request for a purchase equivalent to SDR 85.05 million under the compensatory financing facility (EBS/88/208, 10/13/88; Sup. 1, 10/31/88; Sup. 2, 11/14/88; and Sup. 3, 11/17/88). They also had before them a background paper on recent economic developments in Trinidad and Tobago (SM/88/225, 10/21/88) and Trinidad and Tobago's letter of intent supporting a request for a stand-by arrangement (EBS/88/234, 11/16/88), which was expected to be considered by the Board in the near future.

The Deputy Director of the Research Department made the following statement:

> The calculations underlying Trinidad and Tobago's request for a compensatory financing purchase were based on oil price projections prevailing at the time when the staff paper was prepared. For the projections being made in connection with the forthcoming stand-by request, a somewhat different price forecast, which reflected more up-to-date information, was being used. In the circumstances, the question arises whether Trinidad and Tobago's entitlement to draw under the compensatory financing facility should be recalculated using more up-to-date price projections.
>
> A number of points should be considered in this connection. First, the international oil market is extremely volatile. Present prices are heavily affected by uncertainty concerning the likely course of global oil output. If the supply situation in the oil market stabilizes, prices may rise in the future. Thus, although a forecast made today might be lower than that used in the staff paper supporting the compensatory financing request, the earlier forecast cannot be completely rejected. A second consideration is the obvious practical difficulty of recalculating a country's entitlement to draw in response to

short-term shifts in market conditions in the period between the issuance of a staff paper and its consideration by the Board. The size of the shortfall is computed at the time of the staff's discussions with the member's authorities and has important implications for their financial planning.

Moreover, even with the lower petroleum price projections, Trinidad and Tobago's request would, in the staff's view, be fully consistent with the criteria for purchases in the lower compensatory financing tranche. These criteria require a reasonable assurance that policies are being implemented to correct the member's balance of payments problems. The staff believes this to be the case, as evidenced by the authorities' intention to request a stand-by arrangement on the basis of the letter of intent that was recently circulated. That request, which is expected to be presented to the Board for consideration next month, is predicated on a lower projected level of oil prices.

For the record, if more recent petroleum price projections had been used instead of those used for the world economic outlook exercise, the calculated shortfall would have been equivalent to SDR 72 million, or 42 percent of quota, rather than SDR 91 million. In the circumstances, the staff feels that it is appropriate to continue with Trinidad and Tobago's request on the basis of the data set out in the staff paper.

More generally, issues relating to price forecasts are more likely to arise in the future because the operational features of the contingency and compensatory financing facility require more frequent updating of projections, particularly for key variables such as petroleum prices. The staff proposes that the following approach could be used in instances where there are major changes in projections between the time when the staff paper analyzing the request for a compensatory financing purchase is issued and the time when the request is considered by the Executive Board:

- first, a member's entitlement under the compensatory element of the contingency and compensatory financing facility should be calculated on the basis of information and projections available at the time the paper analyzing the member's request is circulated;

- second, the staff should inform Executive Directors at the time of, or immediately before, the Board discussion of any changes in relevant assumptions with respect to prices and other important variables;

- third, the staff should provide the Board with a judgment as to whether the changed situation invalidates the policy basis for the purchase, namely, that reasonable assurance exists that policies corrective of the underlying payments problems will be adopted; and,

- finally, if the staff judges that the reasonable assurance criterion has not been invalidated and if the Board accepts the staff's judgment, the request for a compensatory financing purchase should be dealt with on the basis of the data and projections originally presented in the staff paper.

The Acting Chairman remarked that it would be useful to circulate to the Board the guidelines suggested by the staff in order to give Directors time to reflect on those guidelines and their future application. He suggested that the request before the Board should be considered on its merits, without creating a presumption about the treatment of future requests.

Mr. Hospedales made the following statement:

The comprehensive staff analysis of recent economic developments and medium-term prospects in Trinidad and Tobago has underlined the widespread and fundamental macroeconomic and structural adjustment initiated by my authorities. The need to adjust the economy to a more manageable and sustainable level had become increasingly urgent since 1982 in the light of the substantial deterioration in the terms of trade caused by the fall in oil prices. In support of their adjustment efforts, my authorities are requesting a lower tranche purchase in the compensatory financing facility with respect to a shortfall in merchandise exports experienced in the 12 months ended June 1988 and have concluded policy understandings for a stand-by arrangement, which will soon be submitted for Executive Board consideration. In this connection, my authorities have found the staff's advice and their active involvement in the process of establishing these financial arrangements to be helpful and constructive.

Economic and financial developments in 1986-88 were shaped primarily by the collapse of international oil prices and declining oil production. The new Government has taken steps over the last 18 months to tailor resource use to resource availability. Fiscal management was strengthened through programs of revenue enhancement and expenditure control and restraint. The programs included initiatives to reduce the public sector wage bill through suspension of cost of living allowance (COLAS) and merit increases, to reduce capital expenditure while enhancing its quality, and to improve the financial position and viability of the state enterprise sector with a view to reducing transfers and subsidies from the Central Government. In addition, my authorities improved exchange rate management by adjusting the exchange rate by 15.3 percent in August 1988, bringing the cumulative depreciation in real effective terms since the beginning of 1985 to 50 percent; and strengthened monetary policies by increasing the rediscount rate by 2 percentage points in August and October 1988 and generally increasing interest rate flexibility.

Reflecting these measures, the overall public sector deficit is being held to 6.9 percent of GDP in 1988, representing an improvement of 3.0 percentage points of GDP over the 1986-87 average, despite a revenue decline in 1988 of about 7 percent owing to lower oil prices. The external current account is being reduced to about 5 percent of GDP in 1988, representing an improvement of 5.0 percentage points of GDP over the 1986-87 average.

The process of adjustment has been difficult and not without significant costs. Thus, although the process of economic decline was arrested in 1988, real GDP is now only 78 percent of the 1982 level; furthermore, unemployment has risen from 10 percent in 1982 to an estimated 22 percent in 1988.

The contraction of the economy and the rising unemployment levels have imparted a sense of urgency to the resolution of an already difficult situation and have prompted the formulation of a comprehensive economic program designed to lay the foundation for a resumption of sustainable economic growth. The economic strategy, which was subject to extensive discussion by all sectors of the community, is defined by a three-year medium-term program covering the years 1989-91 within the context of a seven-year planning framework. The main objectives of the program are to achieve viability in the fiscal accounts and the balance of payments over the medium term; improve public sector resource management; further diversify the productive base of the economy, with emphasis on the traded goods sectors; and foster an enhanced private sector involvement in the process of economic growth.

On present plans, my authorities intend to reduce the overall public sector deficit from approximately 7 percent of GDP in 1988 to 4.0 percent of GDP in 1989 and to 1.5 percent by 1991. With this reduction the recent high level of bank financing to the public sector will be eliminated, ensuring that the private sector is not crowded out.

The realization of this growth-oriented adjustment objective is predicated upon increasing significantly domestic savings. Measures to increase revenues are not under consideration at the present time in view of the general belief that the tax burden is already on the high side; in fact, room for lowering direct tax rates is being provided by a major reform of the tax system, which will shift the burden more onto indirect/expenditures taxation compared with personal and corporate income tax. In the first phase of the tax reform, which will be implemented in January 1989, direct tax rates will be lowered, but this will be offset by a reduction in income tax allowances, exemptions and concessions, and a broadening of the tax base. This phase of the reform will be revenue neutral; implementation of a value-added tax will take place in January 1990--the second phase.

Public expenditure will, therefore, bear the brunt of the burden of fiscal adjustment; after a detailed review of expenditure plans and programs in August 1988, my authorities initiated a wide-ranging program of expenditure reduction, especially current expenditure, which yielded cuts of approximately 3 percentage points of GDP on an annual basis. The process of pruning nonessential expenditures will continue into 1989 with an additional cut of 2 1/2 percentage points of GDP. Pay moderation and employment control will ensure that personnel expenditures in 1989 do not exceed those of 1988. In the medium to long term, public sector employment and the wage bill are to be streamlined through programs of accelerated retirements and voluntary separations.

The public enterprise sector will be subject to wide-ranging reforms involving restructuring, divestment, and closure in some cases, geared to reducing and finally eliminating the need for government support; improved operating procedures already in place are ensuring that transfers are reduced to 3 percent of GDP in 1989, down from approximately 7 percent of GDP in 1987.

My authorities view the revival of investment, which is now averaging about one third of the levels of the 1982-85 period, as crucial to reigniting the growth process. The public sector investment program is seeking therefore to channel resources into priority areas--oil and natural gas, agriculture, manufacturing, and tourism. To complement the investment thrust, further structural reforms to make the economy more efficient are being put in place. These include a phased trade liberalization program, increased flexibility in domestic pricing and in the foreign exchange allocation system, and the easing of restrictions on foreign investment. Such an approach would establish an environment conducive to a revitalization of private sector activity, which is a key objective of my authorities.

Monetary policy will be appropriately strengthened to complement the fiscal consolidation process. Interest rate flexibility and efficiency in financial system operations will be promoted through the establishment of a more market-determined treasury bill rate and through the phased reduction in the secondary reserve requirement for banks. In addition, the program will ensure that there is sufficient credit available for private sector productive activities.

The coordination of fiscal and monetary policies to address macroeconomic disequilibria is being accorded the highest priority by my authorities; but an equally important role is being assigned to exchange rate management to ensure that the process of economic adjustment remains growth oriented and outward looking. The appreciable reduction in real wages that has occurred in recent years has helped to improve Trinidad and Tobago's external competitiveness.

Trinidad and Tobago will still require substantial amounts of external financing to overcome the bunching of debt service payments falling due during the next four years and to increase international reserves so that they bear a more appropriate relationship with import levels. Trinidad and Tobago kept current in its debt service payments despite its worsening balance of payments, but the recent softening of oil prices makes it difficult to reconcile this strategy with initiatives to foster growth-oriented adjustment. Accordingly, my authorities have approached official and commercial creditors to reschedule principal payments falling due in the period September 1, 1988 through August 1, 1992. Agreement in principle has now been reached with the Bank Advisory Committee to reschedule repayments of a significant portion of the medium- and long-term debt owed to banks for 12 years with a 4-year grace period. My authorities are also negotiating project and program loans with the World Bank, Inter-American Development Bank, and the Caribbean Development Bank. My authorities expect that the comprehensive nature of our medium-term economic program against the background of the basic soundness of its economy will have the full backing of the international financial community.

Mr. de Groote made the following statement:

Reading the staff report on the 1988 Article IV consultation with Trinidad and Tobago is a thrilling experience: the first seven pages paint a detailed picture of an economy sliding inexorably toward the brink of virtual implosion. Not until the first paragraph of the summary of policy discussions is the suspense relieved by the statement that even under circumstances such as these, the resumption of sustained growth and the restoration of external viability are still possible. We thus have here a textbook case where the strength and correct implementation of an adjustment program are, in Fund circles, expected to turn the tide, although outsiders might consider such an expectation to be overambitious.

The recent history of Trinidad and Tobago's economic development is one of missed opportunities. The structural diversification program of the 1970s, supported by the enormous oil revenues that poured in during that period, failed to establish a sufficiently diversified economic structure, as is clearly shown by the country's present difficulties. It is well known that adjustment is easier to achieve under conditions of growth. For Trinidad and Tobago, it must now take place under conditions of recession.

Moreover, the economic policy response to the weakening of the oil market at the beginning of the 1980s was neither timely nor appropriate. The decline in oil prices cut national income sharply; according to the background paper, "the terms of trade are estimated to have dropped by a cumulative amount of 34 percent" between 1983 and the present. Despite the onset of this process of national impoverishment, real wages were permitted to continue rising until 1985. This threw the burden of adjustment onto the enterprise sector and even more onto the public sector, causing the latter to pass from surplus into heavy deficit and unemployment to surge. Eventually, the delay in the implementation of internal adjustment brought the external accounts into heavy deficit as well.

Since then, corrective measures have been taken, but the continued deterioration of energy prices has nullified their effect on the existing internal and external imbalances; and the external financing constraint has gradually narrowed to the point where Trinidad and Tobago must now launch a major adjustment effort in the face of the still deteriorating external environment while carrying a heavy burden of accumulated external debt.

Yesterday, the authorities' letter of intent supporting a request for a stand-by arrangement with the Fund was circulated to the Board. Based on the information available at this stage, the proposed program is an appropriate response to the country's present needs. Although the Government's economic program will be considered by the Board in due course, the preliminary reaction of Executive Directors to the envisaged program might also be useful in the further exchanges of views between the authorities and the staff. I will therefore comment briefly on this program. First, in view of the magnitude of the adjustment required, it is vitally important for the authorities to stick to their policy of social consensus, since consensus will be the key to the success of a program that is bound to be unpopular. Second, in light of the considerable effective exchange rate depreciation since December 1985, I wonder whether the exchange rate should still be assigned a major role in improving competitiveness. The answer to this question must be consistent with the need to preserve Trinidad and Tobago's low inflation rate, which, in the present circumstances, is one of the few major assets the country possesses. Third, although I understand that the Government plans to reform the tax system and that the reform will take place in two phases, it is not clear what kind of global tax burden is finally being aimed at. In his introductory statement, Mr. Hospedales mentioned that the first phase of the fiscal reform will be revenue neutral. What then will be the effect of the introduction of the value-added tax in the second phase? Fourth, does the Government's public sector investment program for 1989-91 pay sufficient attention to the integration of foreign companies through joint ventures? This question refers specifically to the four major investment projects in the chemical and energy sectors which have already been identified.

It is particularly satisfying that Trinidad and Tobago's request for a compensatory financing purchase is part of a medium-term economic policy program linked to a stand-by arrangement with the Fund. Since one of the most important criteria for the use of the compensatory financing facility is the temporary nature of the export shortfall, some elaboration by the staff was needed to provide assurance that the request meets this criterion. I am therefore grateful to the staff for its correction of the estimation of the shortfall. Indeed, owing to the fact that Trinidad and Tobago's earnings from petroleum exports in the postshortfall period were based on forecasts for the recent world economic outlook exercise--which projected that oil prices would recover by about 5 percent in 1989--the impact of a lower oil price assumption on the duration of the export shortfall and on the magnitude of the shortfall itself had to be taken into account. I am satisfied that with this correction, the country still qualifies for the recommended purchase, and while I recognize that more time is needed to examine the guidelines suggested by the staff, I could agree to their application, on a nonprecedent basis, to the request before us.

Trinidad and Tobago is requesting financial assistance from both the Fund and the World Bank. Could the staff indicate which measures have been taken or are planned to ensure efficient collaboration between these two institutions in this case? Also, could the staff confirm that the country will again become eligible for World Bank loans in 1989?

Mr. Enoch made the following statement:

Trinidad and Tobago faces severe problems. Real GDP has fallen by almost one fourth since 1983. Unemployment has risen in each of the last five years and is now at the deeply worrying level of 22 percent. In the face of these problems, the authorities have shown considerable resolve. They have repeatedly cut central government spending to try to control the public sector deficit. More recently they have devalued the currency and have introduced structural reforms. Despite these efforts, there are now substantial internal and external imbalances. International reserves are at a critically low level, and the country's liquidity is insufficient to meet all of its basic needs.

The cause of the problem is the dominant position of oil in the economy. Oil revenues would probably have declined gradually, as oil stocks were depleted, even in the absence of a fall in oil prices. But the fall in prices has accelerated this decline, and the substantial and rapid fall in revenues has made adjustment much more difficult. As the economy has contracted, the investment needed to reduce Trinidad and Tobago's dependence on oil has dried up. What is needed now is new investment and diversification, especially in the traded goods sector.

The fiscal deficit is a serious barrier to increased domestic investment. The authorities have cut central government expenditure, but a deficit equivalent to 7 percent of GDP remains. I welcome the indication in Mr. Hospedales's statement that the authorities intend to reduce the deficit to 4 percent of GDP in 1989 and to 1.5 percent by 1991. It is perhaps unfortunate that capital expenditure, which has fallen both absolutely and as a share of GDP in each of the last five years, has borne the brunt of the cuts so far. Current expenditure has declined much less in absolute terms and has remained broadly constant as a share of GDP. Similar trends can be observed in the public utilities and other public enterprises. Obviously, it is difficult to cut current expenditures--and in this context I note with concern the decision of the Industrial Court on Cost of Living Allowances for government employees--but the share of current expenditure must be reduced if resources are to be freed for both public and private investment. I welcome Mr. Hospedales's assurance that his authorities intend to act vigorously in this area.

Monetary policy should also be geared to the restoration of investment levels. The authorities clearly face difficulties over their interest rate policy. I understand and sympathize with their unwillingness to raise interest rates on loans because of the effect on indebted businesses. However, positive real interest rates are necessary to encourage saving and the repatriation of capital. I therefore welcome recent moves in this direction, notably the increases in rediscount rates over the last three months.

The current account of the balance of payments has improved this year despite further falls in oil exports. I commend the authorities for their recent decision to devalue, and I hope that this will bring about further improvement in the balance of payments. The authorities need to assess Trinidad and Tobago's competitiveness carefully and be prepared to take further action on the exchange rate if necessary. Recent falls in oil prices are likely to make further exchange rate adjustment more necessary. The oil price assumptions in the staff paper now look optimistic, and it is reassuring that the request for a stand-by arrangement will be based on up-to-date assumptions. Meanwhile, substantial financing gaps are projected over the medium term, mostly because of the concentration of debt repayments falling due in the next few years. I am pleased to hear that agreement on rescheduling has been reached in principle with the Advisory Committee. I hope that final agreement can be reached soon.

Arrangements for the deferral of debt repayments are an essential step in financing the adjustment process. But further efforts are needed. I welcome the prospect of a comprehensive, Fund-supported program. While the Board will obviously need more time to examine the proposed program, the authorities' letter of intent seems to be along the right lines. However, I would have felt more comfortable if the request for a compensatory financing purchase had been presented together with the request for a stand-by arrangement, and also if the rescheduling discussions had been completed. The requested compensatory financing purchase alone is not nearly enough to meet Trinidad and Tobago's financing needs, and it is regrettable that the Board has to take a decision at this stage. However, in view of the progress that the authorities have already made in tackling their problems and the urgency to complete the compensatory financing transaction before the extension of the transitional period expires, I can fully support Trinidad and Tobago's request.

Mr. Feldman made the following statement:

The authorities of Trinidad and Tobago are requesting a purchase of SDR 85 million under the compensatory financing facility to compensate for a shortfall in export earnings of SDR 90 million for the year ended June 1988. The reasons for the export shortfall, such as movements in international prices--particularly petroleum prices--can be attributed to factors mostly beyond Trinidad and Tobago's control. The request is therefore clearly justified, and I have no difficulties in supporting the proposed decision.

The decline in international petroleum prices since 1982 has restricted earnings from petroleum exports and has increased the current account deficit of the balance of payments. Petroleum exports for 1988 are projected to be only one half of their level in 1984. This decline has had a considerable negative effect on total export earnings, which, compared with their level in the two preshortfall years, fell by 18 percent during the shortfall year. However, export levels are expected to recover slightly during the postshortfall years, partly owing to a medium-term program of adjustment already under way.

The authorities are seeking to strengthen their program by adopting measures in 1989 to be supported, in part, by a stand-by arrangement with the Fund, as indicated in their letter of intent dated November 15. Trinidad and Tobago's efforts to implement a comprehensive set of economic measures and to overcome a difficult economic and financial situation undoubtedly require the support of the international financial community.

Economic activity and unemployment have continued to deteriorate over the past two years, and investment is now about one third of its 1982-85 level. From a longer perspective, since the early 1980s real GDP has contracted by more than one fourth, the unemployment rate has more than doubled to 25 percent, and international reserves have declined to critical levels. The financial system has also been weakened by solvency and liquidity problems, as reflected in the increasing difficulties in bank loan recovery and in the decline of private financial savings.

In the circumstances, a package of economic measures should be designed to promote growth, stimulate investment and employment, and strengthen the balance of payments. A primary concern in this respect is how to boost private investment. Some measures considered by the authorities--for instance, those related to import liberalization and the reduction in public employment--could lead to this result in the long run, but they could also reduce domestic demand in the short run. Such measures require time to produce positive results, and at present it is difficult to see how the country can afford any further decline in economic activity or in its standard of living. Consequently, it is important to secure an adequate flow of external financing to cushion the effects of the demand-management policies to be included in the new program.

The careful design and timely implementation of policy measures is called for. These measures should include structural reforms to help diversify the productive base. It is important that steps be taken to promote the production of traded goods other than petroleum, thereby reducing the relative importance of petroleum in total export earnings as well as the country's vulnerability to external shocks.

I look forward to the forthcoming discussion on Trinidad and Tobago's request for a stand-by arrangement. At that time, the Board will have the opportunity to consider in greater depth the adequacy and effectiveness of the policy measures contained in the ambitious program that the authorities are about to implement.

Mr. Haynes made the following statement:

The Trinidad and Tobago economy has experienced a major economic downturn since 1982, reflecting in large measure the dramatic impact of a steep deterioration in its terms of trade. Declining revenues and a severe hemorrhaging of international reserves have led to sharp cutbacks in public expenditure and the imposition of import controls. Following 20 years of unbroken growth, economic activity is now experiencing its sixth year of decline, and the unemployment rate has more than doubled.

As noted in the letter of intent, Trinidad and Tobago's problems are partly attributable to the weak performance of the industrial sector and to the stance of demand-management policies during the boom years. However, since the onset of this crisis, the authorities have become increasingly responsive to the need to adjust their economy. Unfortunately, they underestimated the trend in international oil markets, and as a result, economic policies lacked the comprehensive character needed to achieve early and effective adjustment. I welcome the assurances provided by Mr. Hospedales that the authorities, as part of a seven-year comprehensive macroeconomic plan, have devised a three-year medium-term program. The objectives of reducing external and internal imbalances through economic diversification, private sector involvement, and improved public sector management are especially crucial at this time and should help put the economy back on a sustainable noninflationary growth path.

It is perhaps paradoxical to suggest that Trinidad and Tobago's strength during the boom years has been a major source of its current weakness. Nonetheless, it is true that the oil sector's revenues, which facilitated large public sector expenditures and stimulated economic activity, also fueled increases in prices and wages, inducing a neglect of some sectors and leading to general uncompetitiveness in manufacturing. The authorities' efforts to reverse these negative trends so as to rekindle private investment and promote a broader-based economy is therefore welcome. In particular, recent exchange rate changes and wage trends have helped to reverse much of the decline in competitiveness. There already appears to be some evidence of their beneficial impact as exports to the Caribbean Community (CARICOM) have started to grow modestly. However, this market remains small and depressed, not least because of Trinidad and Tobago's own decline. The authorities will need to pay constant attention to competitiveness in an attempt to enter extraregional markets.

I welcome the authorities' renewed focus on fiscal policy. They have already given evidence of their willingness to take firm action to cut expenditures; for example, by their initiatives announced in the July/August measures and by their firm stance on public sector wages. In addition, by closing three state enterprises and by cutting transfers to public enterprises, they have sent strong signals regarding the need to improve the efficiency of public enterprises.

On the revenue side, I support efforts to improve the efficiency of the tax system through a reduction in tax rates and exemptions and through transferring the tax burden to indirect taxes. These measures should help the nonpetroleum sector to absorb a larger share of the tax burden and thereby prevent the volatility of revenues associated with dependence on taxes from the oil sector.

The authorities have indicated their intention to pursue a less accommodating monetary policy than in the past. Credit is projected to increase by only 2 percent, which leaves the authorities little room for maneuver. The authorities need to monitor closely developments in the commercial bank sector, which has been burdened by poor loan recovery and has sought recourse to the Central Bank to cover reserve deficiencies. Intensification of the Central Bank's supervisory functions appears warranted. The decision to phase out the secondary reserve requirement in line with the reduced needs of the public sector and to restructure the treasury bill market to enable higher yields should provide added incentive for the authorities to maintain fiscal discipline.

Clearly, the medium-term prospects for Trinidad and Tobago are difficult and uncertain. After the major contraction of output in recent years, economic activity is anticipated to recover slowly, beginning in 1990. With the rate of unemployment already over 20 percent, I wonder whether growth rates of the order expected by the staff are adequate to have a significant impact on unemployment before the late 1990s.

Progressive improvements in the current account are expected, but it is evident that for some time the international community, including the Fund, will have an important supportive role to play in Trinidad and Tobago's efforts. It is worth noting that despite its external difficulties, including declining reserves and rising debt service costs, Trinidad and Tobago has maintained an admirable record of servicing its debt. With the depletion of its reserves, financing gaps, which appear coverable by rescheduling and multilateral assistance, will emerge over the medium term. I believe that in the past two years, Trinidad and Tobago has made a courageous and reassuring beginning to its adjustment effort, and that with continuing effort, it will successfully tackle its difficulties.

Mr. Pineau made the following statement:

Because Trinidad and Tobago's request for a stand-by arrangement will not be considered by the Board before the end of the year, it is difficult to comment at length today on the severe economic problems that the country is facing and the corrective measures that are called for. In the circumstances, I will focus my remarks on the conditions under which the compensatory financing purchase is to be made. In addition, on the basis of the authorities' letter of intent, I will also make some preliminary comments on the main policy areas where the thrust of adjustment should be applied.

Trinidad and Tobago's request for a compensatory financing purchase is fully consistent with the guidelines governing the use of the facility prior to the establishment of the compensatory and contingency financing facility. The existence of a substantial export shortfall, stemming from a sharp deterioration in the country's terms of trade, should have prompted the authorities to make a request earlier. This somewhat lagged response to an exogenous shock helps explain the choice of a reference period that tends to minimize the calculated shortfall. In any event, the fact that the estimated shortfall is to be almost fully covered by the purchase should not be questioned: Trinidad and Tobago is not indebted to the Fund and, above all, its record of cooperation is excellent, as illustrated by the ongoing negotiation of a Fund-supported program. Nevertheless, as a matter of principle, this situation should be avoided in the future. The approach outlined by the staff at the beginning of this meeting could prove helpful in this regard.

The letter of intent leaves no doubt about the authorities' readiness to come to grips with the severe imbalances in the economy. After six consecutive years of recession, a more thoroughgoing adjustment effort appears inescapable. The economic environment that is likely to prevail in the foreseeable future implies, first and foremost, a significant scaling down of the public sector's deficit and operations.

The authorities' focus on expenditure cuts is advisable. However, the short-term net cost of the proposed early retirement scheme for civil servants and the uncertainty surrounding the pay policy after the Industrial Court's decision on cost of living allowances should lead the authorities to keep open other options. In particular, the poor performance of state-owned industries suggests a more forceful approach to privatizing those enterprises which are likely to attract foreign investment. This approach would also prove useful in the future for minimizing the risk of inefficient investment projects.

Over the recent period, monetary policy has been seriously constrained by the weak position of public finances. A policy of positive real interest rates is the only way to consolidate domestic private savings and induce the repatriation of flight capital. Associated with the unavoidable streamlining of bank portfolios, this would help bring down the cost of financial intermediation.

On the external side, the priority remains a far-reaching liberalization of the trade and exchange regime. It is therefore reassuring to note that negotiations have been initiated with the World Bank on this important issue. Significant progress in this area will reinforce the need for a close monitoring of the exchange rate, with a view to restoring the external viability of the economy.

I look forward to examining the proposed program in support of the authorities' request for a stand-by arrangement with the Fund, which is expected to include a contingency financing clause.

Mr. Marino made the following statement:

The economic developments in Trinidad and Tobago over the last five years underline the harsh realities that many oil exporting countries have confronted since the weakening of the international oil market. Under such unfavorable external circumstances, the authorities' constructive reaction to the current situation is welcome. Unlike previous balance of payments crises, when the current account deficit was narrowed by a sharp cutback of imports mostly through import restrictions and exchange controls, on this occasion the corrective actions are mostly market oriented and directed toward constructing a medium-term framework that will permit Trinidad and Tobago to return to a path of sustained economic growth.

The recent exchange rate depreciation will help adapt the economy to the pronounced deterioration in the terms of trade. Additionally, the sizable budget cuts and the increase in the central bank lending rate will contribute to achieving macroeconomic balance in the medium term. However, due regard should be given to debt service obligations, which are projected to rise through 1990. To restore the viability of the external sector, financing by multilateral lending institutions and commercial banks has to materialize. It is hoped that a prompt agreement on debt rescheduling will be reached so as to help promote an important recovery of private investment flows and equilibrate the capital account.

The comprehensive economic program that the authorities intend to implement has the monumental task of achieving viability in the fiscal accounts and the balance of payments in the medium term. The severe deterioration in the terms of trade over the last five years, coupled with the decline in GDP of more than 25 percent over the same period and an unemployment level of 25 percent, leaves little room for maneuver. In this regard, the most promising area for corrective action is on the microeconomic front. One of the great lessons of the fall in oil prices for economies highly dependent on oil exports is the need to diversify the economic structure. For Trinidad and Tobago diversification is particularly important, since its oil endowment will be exhausted in little more than a decade.

The proposed participation of the World Bank and the Inter-American Development Bank in Trinidad and Tobago's program to restructure the productive sector is welcome. Certainly, by helping to identify investment opportunities and financing specific projects, these multilateral institutions can contribute toward the structural adjustment required in Trinidad and Tobago. It is hoped that many investment opportunities in the nontraditional manufacturing industries as well as in the tourism sector will be detected. This restructuring program will supplement the three-year public sector investment program recently unveiled by the Government. It is encouraging to see that the program will be supported by US$75 million from a variety of bilateral and multilateral sources.

On the fiscal front, the authorities should be commended for their innovative and courageous efforts to reduce the public sector wage bill. The outcome of their voluntary termination of employment plan will be followed with great interest.

Trinidad and Tobago's economic program seeks to adapt the economy to current world economic realities in a positive manner. From the staff analysis it is evident that the shortfall in Trinidad and Tobago's export earnings was beyond the control of the authorities. I can therefore support the proposed purchase under the compensatory financing facility.

Mr. Fernando made the following statement:

Having noted the more up-to-date information regarding the export projections underlying the calculation of the compensable shortfall, I can agree to consider Trinidad and Tobago's request on the basis of the data available at the time the staff paper was issued. In supporting the request, I agree with the staff that the shortfall is due to circumstances largely beyond the authorities' control and that the test of cooperation has been substantially met. I would note, however, that the complexity of the authorities' task and the financing constraints would have been less daunting at this juncture if the current state of policy articulation had been reached last year when the export shortfall was greater.

Clearly, the authorities' policy objective is to increase savings and maximize the efficiency of past investment. I recognize that the economic environment, after successive years of contraction, is least conducive to generate a higher level of savings. Moreover, the prospects for growth both in the near term and in the medium term are not promising. In this context, the importance of creating domestic conditions that serve to build up confidence should be stressed so that private capital can find secure, attractive investment outlets within the domestic economy. Exchange rate action and sound monetary conditions could also play an important role in repatriating flight capital. In the situation of Trinidad and Tobago, foreign direct investment can play an important role in view of its nondebt-creating character and its contribution to the evolution of a sustainable balance of payments position.

The impetus for reducing internal imbalances should come mainly from the ongoing focus on public enterprises. In a situation where the burden of fiscal adjustment is on expenditure restraint, improved conditions for public enterprises will reduce public dissaving as well as contribute to real output. The authorities have rightly recognized this fact, judging by their efforts over the previous two years to increase enterprises' revenues. Even though substantial revenue increases have been achieved along with cost restraint, the ground yet to be covered--reflected in operating deficits in such areas as transport and telephone services--is indicative of the substantial misalignment between costs and pricing to date.

Two specific points are in order. First, the accounting framework of public enterprises needs to be considerably strengthened so that the authorities have accurate indicators to measure the success of adjustment, and in particular, to track the overall public sector deficit. Second, even with substantial budgetary transfers to cover operating deficits as well as capital expenditures, most public enterprises have had to resort to bank financing to meet cash requirements. In the light of the incidence of nonperforming loans in the portfolios of commercial and development banks, a potential pressure point exists for further budgetary outlays to settle overdue obligations. More important, it is vital to ensure that future bank financing is based strictly on creditworthiness considerations; otherwise, public enterprise operations could be a burdensome contingent liability on the budget, putting at risk the other adjustments undertaken and contemplated. Staff comment on the safeguards to avoid this possibility would be helpful. The crucial role that policy with respect to the public enterprises should play to achieve expenditure reduction and eventually contribute to public savings is underscored by the inherent limitations to the implementation of wage policy.

Monetary policy should play an effective complementary role to promoting financial savings. The financial sector is segmented, and structural reforms of sufficient scope and depth are required to provide the necessary conditions for the interest rate instrument to play its allocative function. I welcome the authorities' desire to reduce the restraints on interest rate flexibility and their intention to harmonize short-term rates through appropriate changes to the treasury bill auction system. While the greater responsiveness of interest rates to market forces is an important step in credit allocation, it is equally important to assure that the Government is sensitive to market interest rates and that its borrowing is disciplined by fiscal targeting in general and by market signals in particular. This wider objective of the treasury bill rate is necessary if credit is not to be pre-empted by the Government.

Trinidad and Tobago's track record of debt servicing should catalyze the consensus necessary to obtain temporary relief through debt rescheduling. The adjustment program which the authorities are developing further should recreate the capacity for growth and the achievement of external conditions to meet the higher level of maturing obligations after debt rescheduling. I encourage the authorities to implement the program in a resolute and pragmatic manner.

Mr. Ismael stated that he was in broad agreement with the thrust of the staff's appraisal in its report for the 1988 Article IV consultation with Trinidad and Tobago. The authorities should be commended for the significant corrective actions recently introduced to cope with the problems caused by a renewed decline in international oil prices in 1988. He noted with satisfaction that many of the Board's recommendations on the occasion of the 1987 Article IV consultation had been implemented, and that others had been incorporated in the comprehensive measures to be implemented in 1989.

It was encouraging to note that as a result of the strengthening of fiscal management, the improvement in foreign exchange rate management, and the strengthening of monetary policies, the overall public sector deficit had been significantly reduced, the external current account had been halved, and the process of economic decline had successfully been arrested, Mr. Ismael continued. He welcomed the authorities' intention to strengthen their efforts further by the adoption of comprehensive measures in 1989 and by the conclusion of policy understandings for a stand-by arrangement, which would soon be submitted for the Board's consideration.

On the external front, it was regrettable that Trinidad and Tobago maintained a restriction on import payments, Mr. Ismael noted. He urged the authorities to eliminate that restriction as quickly as possible.

He welcomed the agreement reached by the authorities with the commercial banks to reschedule repayment of a significant portion of Trinidad and Tobago's debts so as to avoid a bunching of repayment obligations in the next few years and ensure a viable balance of payments, Mr. Ismael remarked. The rescheduling would provide a period of relief to improve the fiscal situation, so that debt obligations could be met on a sustained basis in the future.

With regard to Trinidad and Tobago's request for its first purchase under the compensatory financing facility, he was satisfied that all of the requirements set forth in the decision governing that facility had been met, and he could therefore support the proposed decision, Mr. Ismael commented. The guidelines to be followed in the face of the volatile oil situation, as outlined by the staff at the beginning of the discussion, seemed to be reasonable.

Trinidad and Tobago had made positive strides in its adjustment effort and therefore deserved the Fund's financial support, Mr. Ismael considered. He was looking forward to the forthcoming discussion of Trinidad and Tobago's request for a stand-by arrangement. Moreover, he was confident that the authorities would continue with commitment and determination their effort to achieve adjustment with growth.

Mr. Ghasimi made the following statement:

> Trinidad and Tobago is a small oil exporting country badly hurt during recent years by the sharp drop in oil prices and the price of other commodities. I broadly agree with the staff's appraisal for the 1988 Article IV consultation and to the request for a purchase under the compensatory financing

facility. Trinidad and Tobago has consistently cooperated with the Fund and has heeded the Fund's advice by implementing courageous and timely adjustment measures. In this regard, it is not surprising that the authorities, faced with a further drop in oil prices, did not hesitate to devise a strong adjustment program in a medium-term framework, for which they are requesting a comprehensive financial package, including compensatory financing and a stand-by arrangement from the Fund.

This case illustrates the sharp reversal in the plight of oil exporting countries from the situation prevailing in the 1970s. Trinidad and Tobago, which has never before used Fund resources, was graduated from World Bank lending in 1979. Now, owing mainly to unforeseen and exogenous factors, this country has to rely on Fund resources for balance of payments financing and resume borrowing from the World Bank. In my view, oil exporting developing countries deserve the full cooperation of the international financial community which benefited from their contribution to the smooth functioning of the international monetary system in the 1970s and early 1980s. In this connection, as this chair emphasized during the discussion on the work program, my authorities welcome the study to be undertaken on the situation of oil exporting developing countries in the framework of the forthcoming world economic outlook exercise, and they encourage management and the staff to focus well-deserved attention on this group of countries.

The Trinidad and Tobago authorities should be commended for not only having introduced needed corrective actions but also having engaged in structural reforms aimed at diversifying the economy. Diversification is an important element of the medium-term program since the problems of Trinidad and Tobago seem to stem also from a declining oil production owing to aging wells.

As has been underlined by Mr. Hospedales, the authorities seem to concur with the staff on the major elements of the program. I have nothing to add in this regard, except to express the hope that after Trinidad and Tobago agrees on a stand-by arrangement with the Fund, official as well as private creditors will be generously forthcoming so as to allow the adjustment process to proceed smoothly and in a timely manner.

Regarding the compensatory financing request, I agree with the Acting Chairman's comments. Trinidad and Tobago fulfills all the requirements of the decision on compensatory financing with respect to balance of payments need, the test of cooperation, and the exogenous character of the causes of the shortfall. More generally, and in view of developments in oil markets, I am somewhat surprised at the small number of compensatory financing requests from oil exporting countries. Could the staff comment on this point; specifically, have other requests been received, and what is the staff's reaction to such requests, if any?

Mr. Alfiler made the following statement:

Clearly the most bothersome aspect of developments in Trinidad and Tobago is the continuous deterioration in aggregate production and income. Together with the increase in the rate of unemployment from 11.1 percent in 1983 to 21.6 percent in 1987, this deterioration has resulted in a significant decline in per capita income, which in 1987 alone dropped by an estimated 19 percent.

The staff documents traced these developments mainly to the sharp drop in the international price of petroleum and, paradoxically, partly to the authorities' efforts to maintain the country's production and income levels in the face of an adverse international market. Certainly, the authorities implemented measures to reverse the deteriorating trend, including currency depreciation and measures to shift public expenditures from current expenditures--namely, wages--to capital expenditures. But obviously, these efforts fell far short of what was needed.

It is therefore reassuring to note from Mr. Hospedales's statement that the authorities have strengthened both demand-management and structural measures since late 1986 and have finally evolved a medium-term program within the context of a seven-year planning framework as the basis for a comprehensive approach to their adjustment effort. The main objectives of the medium-term program, as elaborated by Mr. Hospedales, appear to be in the right direction. Obviously, a diversification away from a petroleum-based trade sector is the most essential element. Equally important is the improvement in the overall efficiency of the fiscal sector in support of efforts to encourage the private sector to play a greater role in achieving the diversification objective. I will reserve further comment on the medium-term framework until the forthcoming discussion on Trinidad and Tobago's request for a stand-by arrangement.

At this stage, I would commend the authorities for their demonstrated resolve in addressing the problem of an unsustainable fiscal deficit to GDP ratio, and in maintaining competitiveness through currency adjustment, wage restraint, and trade liberalization--all of which are essential elements in their effort to restore sustainable growth and external viability. I would also encourage the authorities to persevere in reducing the two largest current expenditure items in the budget, namely, wages and transfers. On the wage bill, the adverse decision by the Industrial Court on Cost of Living

Allowances is considered by the authorities as a minor setback which could be overcome. But the decision also indicates the difficulty in legislating wage cuts. It may be more appropriate to reduce the public wage bill through a more active reduction in public sector staffing. It may therefore be necessary to supplement the voluntary severance and accelerated retirement scheme with other schemes, say, to identify and abolish redundant public sector positions.

I welcome the authorities' intention to restructure, divest, and, in some cases, close state enterprises. An efficient monitoring group is essential in this exercise; otherwise, an accumulation of leakages in expenditure control could negate the overall objective.

The cuts in the wage bill and transfers should make it easier to resume capital spending in support of tourism and infrastructure investments for trade and manufacturing without increasing further the public sector borrowing requirement. In turn, increased public investment should generate a sympathetic response from the private sector, thus allowing for the reversal of the declining trend in production and incomes.

I would also note the importance of external financing in the adjustment process. It is encouraging to learn that the authorities and the country's commercial creditors have agreed in principle to a rescheduling of medium- and long-term public debt. The cushion that will be provided by the compensatory financing purchase should also assure that reserves will be adequate if external developments continue to be unfavorable. I am confident that the international financial community, including the multilateral development institutions, will recognize Trinidad and Tobago's efforts and will contribute to filling the financing gap over the medium term. I support the proposed decision.

Mr. Templeman made the following statement:

Trinidad and Tobago's economy has undergone difficult times in the last few years, largely owing to adverse oil price developments. Some impressive corrective measures have been taken, but a comprehensive program sufficient to cope with the evolving situation has been lacking. In the meantime, persistent negative real growth and rising unemployment have increased the urgency of adopting a comprehensive medium-term approach to reduce domestic and external imbalances, introduce structural reforms, and bring about economic diversification.

Some important economic aims have been set out in the economic plan for 1989-91, such as the targeted reduction in the public sector deficit ratio of 1.5 percent of GDP and in the current account deficit ratio of 2.5 percent of GDP for 1991. However, it is not yet clear that the full array of policies needed to achieve these aims has been identified and that a timetable for their implementation has been adopted.

I note from Mr. Hospedales's statement that his authorities have concluded policy understandings for a stand-by arrangement, which will soon be submitted for Board consideration. While it would have been convenient to have considered that request at the same time as the report on the Article IV consultation and the compensatory financing request, the circulation of the letter of intent does provide evidence that the authorities are moving to adopt a comprehensive medium-term adjustment and reform program. Certainly, a strong program will be needed to generate support for debt rescheduling or any other external financing that may be needed to fill the substantial financing gaps foreseen in the next few years.

Since our discussion of the 1987 Article IV consultation, some progress has been made in areas of concern to the Board, mainly with regard to wage restraint, a reduction in the public sector deficit ratio and the current account deficit ratio, preparation for tax reform, exchange rate devaluation, and somewhat greater interest rate flexibility. The achievement of a promising degree of wage restraint is a positive factor in holding down domestic demand to reduced income levels in the wake of the decline in oil prices. This should help protect the country's international competitive position. A comprehensive effort to reduce the public sector deficit, while creating better incentives for savings, investment, and exports, seems to be under way but is still at an early stage. Fairly good progress has already been made in reducing the central government expenditure ratio. However, some question arises as a result of the decision by the Industrial Court to require retroactive payment of the suspended cost of living adjustments. It is reassuring that the authorities are prepared to seek offsetting salary adjustments by legislative action, or by agreement with the unions, but I wonder what the prospects are for success with either option. The ability of the Government to reduce transfers to the public enterprises will depend on the broader question of the restructuring of enterprises, which does not yet seem to be fully spelled out, although the letter of intent contains some interesting information in that regard.

On the revenue side, a shift in the burden of taxation from income to expenditure seems appropriate. The reduction in direct tax rates coupled with the reduced income tax exemptions and concessions, scheduled for January 1989 should be a step in the right direction, as would be the planned introduction of a value-added tax at the beginning of the 1990s.

The need to finance the large fiscal deficit substantially from domestic funds and to provide financing to troubled banks has impeded the free exercise of monetary policy. It has also impeded the creation of a more efficient system of financial markets and financial instruments for mobilizing and efficiently allocating resources to foster the recovery and diversification of economic activity. The introduction of greater interest rate flexibility is welcome, but it is still not clear that interest rates are generally positive in real terms, and a weak banking and nonbank financial system continues to need attention.

There has been a notable reduction in the current account deficit ratio from the high level of 14 percent in 1986, but a ratio of 5 percent is still high, and nearly all of the adjustment has been on account of declining imports. The substantial real effective depreciation of the Trinidad dollar and success in wage restraint provide an improved environment for further strengthening the external accounts. But the continued existence of the restrictive system raises questions about the adequacy of the exchange rate. My authorities will review with interest the trade and payments liberalization measures that are to be embodied in the program in support of the proposed stand-by arrangement. Also, careful management of debt and an improved environment for foreign direct investment could contribute to the achievement of a viable external position over the medium term. In this regard, I urge the authorities to focus future external assistance flows, especially from multilateral sources, on export diversification activities.

I can support the request for a compensatory financing purchase, which appears to meet all the relevant criteria. However, it should be pointed out that there is an element of secular decline in oil production, which is not a temporary feature of the downturn in exports, and the depletion of wells has been accompanied by the effects of some policies that were not outside the control of the authorities. I recognize that some measures in the tax field have now been taken to prolong oil production, but the need for export diversification is clear. Like Mr. de Groote, I can go along with the compensatory financing request, despite the fact that owing to a further fall in oil prices, the shortfall is less than the amount of the request. This situation is regrettable, and the Board's decision should not be considered as a precedent. The Board will need to consider carefully the staff's suggested guidelines for dealing with such cases.

Finally, a brief passage in the staff paper attests to Trinidad and Tobago's capacity for meeting its financial obligations to the Fund. As a matter of principle, some explicit statistical analysis would have been welcome, for example, in the medium-term projections in the report on the Article IV consultation.

Mr. Fuleihan made the following statement:

The economy of Trinidad and Tobago exhibits the classic symptoms of the "Dutch disease," whereby the spending effects resulting from the emergence of a single dominant export sector lead to a withering away of the remaining tradable sectors. Coupled with an appreciation of the real effective exchange rate and a rapid expansion of real wages, the process culminates with the collapse of the dominant export sector.

The authorities are currently grappling with the adverse consequences of the collapse in world oil prices. While they have attempted to address the ensuing economic imbalances, the initial measures have been ad hoc in nature and, at times, counterproductive. Indeed, the massive reduction in public expenditures, although necessary, has been heavily biased against capital expenditures. Moreover, the attempts to contain the current account deficit through a series of trade restrictions and a two-tier exchange rate have aggravated the inefficient allocation of resources and have depleted foreign exchange reserves.

More recently, however, the authorities have embarked on a comprehensive medium-term strategy to deal effectively with the internal and external dislocations. It is evident that fiscal contraction is pivotal for the success of this strategy, and, in view of the existing tax levels, expenditure containment will have to bear the brunt of such contraction. Therefore, the authorities will need to rehabilitate the parastatal sector and rationalize the civil service. With respect to the latter, I note the program of accelerated retirements and voluntary separations. While the resulting decrease in the wage bill over the medium term is welcome, its effects on the unemployment rate--which is estimated at 22 percent--is cause for some concern.

I am also somewhat concerned about the authorities' public investment program. It may not be optimal to invest heavily in energy-intensive labor-saving industries at a time when energy reserves are being depleted and there is substantial unemployment. Moreover, in view of the current uncertainties in the oil market, a trade-off may exist between the short-term benefits of rapid oil extraction and the medium-term consequences. The staff's comments in this regard would be welcome.

The authorities clearly recognize that improvements in the economy's growth potential are dependent on greater private sector participation, particularly in agriculture and agro-industries. Such participation will be facilitated by the authorities' commendable pursuit of direct foreign investment through the revision of the legal code. More important, the recent exchange rate devaluation will enhance competitiveness and could induce a repatriation of flight capital. Regarding repatriated capital, I encourage the authorities to pay due regard to investors' expectations when pursuing their exchange rate policies. Furthermore, any enhanced role for the private sector will need to be preceded by a liberalization of the trade regime.

The authorities have embarked on a comprehensive medium-term adjustment program that confronts the serious economic challenges facing them. Their commitment to reform and the widespread popular recognition of the necessity of adjustment are essential ingredients for the success of the program. Moreover, the shortfall in export earnings and the authorities' record of cooperation with the Fund fully justify the request for a compensatory financing purchase. I can support the proposed decision and look forward to the discussion on a stand-by arrangement in support of the adjustment program.

Mr. Kpetigo remarked that the staff report and Mr. Hospedales's statement had highlighted the impact of declining oil prices on the economy of Trinidad and Tobago since the early 1980s. They also provided a comprehensive analysis of the magnitude of adjustment that had taken place internally in response to the earlier shock.

It was fair to say that considerable progress had been made since 1984, Mr. Kpetigo continued. The Administration that took office late in 1986 had continued the process of adjusting aggregate expenditure to the reduced level of external revenues. As a result of the authorities' adjustment efforts, the fiscal and balance of payments positions had shown improvement through 1987. Meanwhile, Trinidad and Tobago had kept current in its debt service obligations to external creditors.

The authorities' commitment to adjustment commensurate with the magnitude of the country's imbalances had culminated recently in the adoption of a comprehensive program that could be supported by a stand-by arrangement with the Fund, Mr. Kpetigo observed. With those considerations in mind, he could support Trinidad and Tobago's request for a purchase under the compensatory financing facility.

Mr. Kleine said that he wished to endorse the staff's appraisal and that he supported the proposed decision on a compensatory financing purchase.

Since Trinidad and Tobago's supply of crude oil would be virtually depleted in about a decade, the need to push ahead with the diversification of the export sector had become all the more urgent, Mr. Kleine considered. Against that background, he was pleased to note that the authorities were willing to reinforce their program of economic adjustment and were requesting a stand-by arrangement with the Fund. He looked forward to the forthcoming discussion on that request.

Regarding the calculation of the shortfall, the new guidelines presented by the staff needed further reflection and would have to be considered by the Board at a later date, Mr. Kleine remarked.

Mr. Archibong said that in the face of deteriorating international petroleum market conditions, Trinidad and Tobago, like many oil-dependent economies, had experienced serious economic and financial difficulties. External and domestic imbalances had widened, economic activity had contracted, and unemployment had risen. The crucial issue for the economy had been to adjust to the drastically reduced level of resource availability and yet restore the economy to a positive growth path without which the solution to its debt problem might be difficult to achieve.

Aware of that situation and the policy trade-offs that it entailed, the authorities had taken a number of measures not only to counter the effects of the decline in oil prices but also to seek ultimately to diversify the economy, Mr. Archibong observed. Specifically, the series of policy measures adopted in August 1988, including, inter alia, an increase in the central bank lending rate, a devaluation of the Trinidad and Tobago dollar, an increase in the excise duty on gasoline, and substantial cuts in recurrent and capital budgetary allocations, were steps in the right direction. The liberalization of guidelines on the Aliens Landholding Act and the provision of incentives for local and foreign investment could, in the long run, assist in the diversification effort and thus reduce the economy's dependence on petroleum. Moreover, the domestic economic and external sector policies elaborated in the Government's medium-term adjustment program for 1989-91 were adequate and could, when fully implemented, restore growth momentum within a framework of reduced internal and external imbalances.

He had no difficulty in supporting the request for the use of Fund resources under the compensatory financing facility, Mr. Archibong remarked. In the past few years, the authorities had managed their economy prudently, often responding with significant corrective measures to solve balance of payments difficulties arising, largely, from the decline in international oil prices. And, from the staff report, it was evident that Trinidad and Tobago had not only fully met the test of cooperation with the Fund, but that the large shortfall in export earnings was attributable largely to factors beyond the authorities' control. In those circumstances, and because the authorities had already announced and had begun to implement a medium-term program of economic adjustment, he supported the proposed decision.

The staff representative from the Western Hemisphere Department remarked that Trinidad and Tobago's per capita income had fallen to a level that met the World Bank's statistical criteria for eligibility to borrow during 1989. He also noted that a Bank staff mission was currently in Trinidad and Tobago to undertake a further review of the economy. Some policy-based lending might be considered by the Bank's Board in mid-1989; such lending was expected to help fill the identified financing gap for the program in support of a stand-by arrangement with the Fund.

The staff fully shared Mr. Fernando's concerns about the performance and monitoring of the state enterprises, the staff representative continued. The staff had emphasized those concerns in its discussions with the authorities, noting that there was room for improvement in the parastatal area. Some positive steps had been taken in the course of the development of the understandings for the proposed program in order to deal with the possible adverse effects on the program of enterprises' increased reliance on domestic financing. For example, in developing the 1989 budget the Ministry of Finance and the heads of the major enterprises had sought to ensure the coordination of financial planning and to improve the reporting of the enterprises. In addition, as mentioned in the letter of intent, the Government had committed itself to pursue a close quarterly monitoring of those enterprises which continued to be dependent on the budget so as to ensure that their execution of financial programs was consistent with the guidelines and understandings that had been developed. The central authorities also intended to exercise more control over enterprises' authorizations to borrow from local banks, to ensure that such borrowing was in line with the limits determined in the financial program.

The emphasis of the investment program on the energy sector reflected the authorities' awareness that over the next few years the energy sector would continue to be the mainstay of the economy, the staff representative from the Western Hemisphere Department explained. In some respects, investment projects were intended to minimize the rate of decline and deterioration in the existing infrastructure. For example, one project in the area of secondary recovery techniques was expected to improve the yield from existing wells. The authorities also wished to develop and promote the utilization of gas reserves, because they were more abundant than petroleum, and because some projects in that area had export potential. Finally, the authorities wished to protect against a possible shortage of gas supplies, which were used as feedstock in some existing enterprises, around the end of the decade.

The Deputy Director of the Research Department, explaining the Fund's treatment of compensatory financing requests received from oil exporting countries, observed that the Board had established the principle that such requests would be dealt with in exactly the same manner as requests from countries dependent on exports of other primary products. Although only a relatively small number of requests from oil-importing countries had been received so far, several had already been considered by the Board, for example, the requests of Bolivia, Cameroon, Ecuador, and Indonesia.

Perhaps the number of requests had not been greater because until the time of the oil price decline in 1986, few oil-producing countries met the requirement of balance of payments need, the Deputy Director of the Research Department commented. Moreover, for a period of time thereafter it had been difficult for the staff to reach agreement with the authorities concerned on a program that would provide the assurances necessary for the use of the Fund's resources. That difficulty accounted for the delay in bringing the request of Trinidad and Tobago, among others, to the Board for consideration. Nevertheless, discussions on the use of compensatory financing were ongoing with certain oil-producing countries--for example, Mexico--at the present time.

Mr. Hospedales remarked that he wished to thank Directors for their expressions of interest and unanimous support for Trinidad and Tobago's first request to use the resources of the Fund. Directors' comments, which had been both supportive and constructive, would be conveyed to his authorities in Port-of-Spain and would be given due consideration as they embarked on their 1989 budget exercise. That exercise was expected to be completed by mid-December 1988 and would continue to consolidate the process of adjustment and define in a precise manner the additional policy requirements agreed upon in the letter of intent for 1989 and beyond.

His authorities appreciated, in particular, the staff's flexibility and understanding of Trinidad and Tobago's economic situation, including the institutional setting and complex relationships in its economy, Mr. Hospedales continued. That understanding had been responsible for the rapid conclusion of the policy understandings to adapt the country's economic framework and had made possible the Executive Board's consideration of the compensatory financing request at the present time.

On assuming office in December 1986, the new Administration had duly recognized the need for a new orientation in public economic policy based on creating the right incentive framework to enhance efficiency and expand the resource base, Mr. Hospedales observed. Wide-ranging macroeconomic and structural reforms had been implemented over the last 18 months; but through extensive dialogue in the national community, a more structured and consistent policy framework had been laid down, and that framework had been captured in three documents that had been presented to Parliament in August--namely, a seven-year plan, a draft medium-term economic program (1989-91), and a public sector investment program (1989-91). There had also been a midcourse policy correction in August 1988, which had begun to define the policy parameters for a resumption of growth. Moreover, the medium-term economic program had established specific targets that were to be achieved in certain key areas. The annual budget exercise would define specific policy measures as well as tactical responses to changing economic circumstances.

The program of action had already been producing encouraging results in that both the overall fiscal deficit and the external current account deficit had begun to be reduced to more sustainable levels, Mr. Hospedales noted. The objective over the next few years was to continue to reduce financial imbalances while taking steps to put the economy on a sustainable growth path.

Accordingly, public expenditure was being restructured and redirected with emphasis on reducing the scope and size of the public sector, Mr. Hospedales observed. The Government was prepared to take whatever action was required--including legal action--to ensure that the wage and salary bill remained within the programmed limits. The state enterprise sector was developing plans and strategies consistent with reduced government transfers so that its efficiency drive was placed on a sound footing. Divestment and closure in some cases would strengthen that process; for example, Trinidad Cement Ltd. was making its first public offer at the end of the month. The tax system was being overhauled so as to improve its efficiency and elasticity. While the tax reform was to be revenue neutral in 1989, the authorities would use the reformed system to provide whatever additional revenues might be required if the fiscal targets were to be met. The trade and exchange system was being progressively liberalized within a well-defined timetable--by September 1989 a substantial dismantling of the foreign exchange allocation budget would be accomplished and so also would be the negative list coupled with the elimination of most price controls; arrangements had been put in place to facilitate foreign investment; interest rates were moving upward as the treasury bill auction became more market oriented--in fact, in the latest treasury bill auction the rate had risen by about 73 basis points; and the exchange rate would continue to remain realistic and competitive.

The private sector was expected to become more active in that environment and a recovery of private investment flows was also expected to take place; but his authorities would be duly conscious of the need to take additional appropriate action if such initiatives did not materialize, Mr. Hospedales explained. A number of projects in the energy sector were either under way--namely, the Southeast Coast Consortium to produce crude condensate for export as well as gas for domestic consumption--or in the process of being finalized--namely, a new methanol plant, a natural gas liquids recovery plant, a secondary oil recovery project, and upgrading of refinery operations. There were other projects in agriculture, manufacturing, and tourism; for example, diversification of CARONI Ltd.--a producer, refiner, and distributor of sugar--into livestock, rice, and citrus. All those projects would require sufficient foreign financing, but emphasis was being placed on funds from multilateral institutions and on nondebt-creating flows. His authorities intended to increase investment to historical levels--approximately 24 percent of GDP--by 1991. To ensure that domestic savings covered a significant proportion of investment, the present current account fiscal deficit would be converted into a fiscal surplus by 1991, and with those policy initiatives, the current account of the balance of payments should become viable and sustainable.

It was therefore hoped that the financing assurances to permit early Board consideration of a stand-by arrangement to support the adjustment effort would soon be in place, Mr. Hospedales observed. The bank advisory committee had recently agreed in principle to recommend a rescheduling of a substantial part of those external debt obligations falling due during the period September 1, 1988 through August 31, 1992. A term sheet was to be sent out during the course of the coming week, and the rescheduling agreement was expected to be in place by the middle of December. Similar arrangements had also been requested of the Paris Club. Additionally, subsequent to a World Bank decision in August 1988 to readmit Trinidad and Tobago to borrower status, a mission was in Port-of-Spain to discuss the modalities for a structural adjustment loan. A high-level mission from the Inter-American Development Bank was to visit Port-of-Spain in early December to discuss a five-year program of operations, and discussions were also taking place with the Caribbean Development Bank. The materialization of those financial arrangements would certainly provide the leverage for the economy to invest, grow, and meet its external obligations and would allow a greater degree of effectiveness in economic management.

In his authorities' view, the new incentive and policy framework represented the most far-reaching economic policy reforms ever introduced in Trinidad and Tobago, Mr. Hospedales remarked. It combined measures aimed at promoting economic efficiency and long-term economic growth with structural measures designed to restore balance of payments equilibrium and maintain price stability. It demonstrated the new Administration's resolve to move from a policy mix emphasizing demand restraint to one of macroeconomic stabilization and structural reform. Indeed, they were moving from a program of austerity to one of adjustment and growth; they were duly conscious of the unpleasant side effects of their program; they recognized the sacrifices that had to be made; but they wished to emphasize that the success of the operation would depend crucially on the support of the international financial community.

The Acting Chairman made the following summing up:

Executive Directors generally agreed with the appraisal in the staff report, and observed that the economic and financial position of Trinidad and Tobago had deteriorated substantially over the past several years as the decline in international oil prices was not met with an adequate policy response. In this connection, they noted that real GDP was expected to decline in 1988 for the sixth consecutive year--accompanied by sharp reductions in investment and a rapid rise in unemployment--and that gross official foreign reserves had fallen to a critically low level.

Directors therefore welcomed the recently intensified efforts that had been made by the authorities to counter the effects of the fall in oil prices and to develop a strong adjustment program set in a medium-term framework that would stress economic diversification and lay the basis for economic recovery and a restoration of external viability. Directors noted that a letter of intent describing the Government's economic program for 1989 had just been circulated on the basis of which a stand-by arrangement would be requested in the near future. Commitment and determination in the implementation of adjustment policies was now of paramount importance. Directors also stressed the important contribution that Fund-Bank collaboration could make to Trinidad and Tobago to help overcome the country's structural economic problems.

Directors observed that fiscal policy had a critical role to play in stabilizing the economy and making room for a reactivation of private sector investment. In this regard, they underscored the importance of the efforts under way to reduce the overall public sector deficit. Directors stressed the need for closer monitoring of the state enterprises by the Central Government in order to ensure that reductions in budgetary transfers were matched by real improvements in the operations of the enterprises. The proposed tax reform was expected to improve the tax effort and economic performance over the medium term.

Directors felt that a restrained credit policy was needed to protect the net international reserve position of the Central Bank. In this connection, they welcomed the recent increases in the central bank lending rate, and they encouraged the authorities to promote increased interest rate flexibility in order to foster a recovery of financial savings and induce more efficiency in banking system operations. This latter objective also would be served by a strengthening of the Central Bank's supervisory function to safeguard the soundness of financial institutions.

Directors emphasized the importance of reforms in the external sector that would improve competitiveness and attract private capital inflows through exchange rate flexibility, the elimination of exchange and trade restrictions, and a relaxation of controls on foreign direct investment. In the view of Directors, these reforms, together with domestic price flexibility, were essential to achieve economic diversification and a strengthening of the balance of payments.

In the light of Trinidad and Tobago's heavy debt service burden over the next few years, Directors welcomed the advances that had recently been made in arranging a rescheduling of debt repayment obligations to foreign commercial banks.

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

The Executive Board then took the following decision:

1. The Fund has received a request from the Government of Trinidad and Tobago for a purchase equivalent to SDR 85.05 million on account of a shortfall in merchandise export earnings. In accordance with paragraph 42 of Decision No. 8955-(88/126), adopted August 23, 1988, and Decision No. 9015-(88/163), adopted November 2, 1988, this purchase shall be governed by Decision No. 6224-(79/135), adopted August 2, 1979, as amended.

2. The Fund notes the representation of Trinidad and Tobago and approves the purchase in accordance with the request.

Decision No. 9020-(88/168), adopted
November 18, 1988

3. BOTSWANA - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Botswana (SM/88/240, 12/28/88). They also had before them a background paper on recent economic developments in Botswana (SM/88/243, 11/3/88).

Mr. El Kogali made the following statement:

The Botswana authorities are grateful to the Fund staff for the analysis of their economy, and they share the concerns raised by the staff in a number of areas. However, they believe that further work is needed to analyze and address the fundamental structural problems facing Botswana. It is obvious from the staff report that, unlike most developing countries, the task of economic management in Botswana has met with considerable success. The challenge that lies ahead is one of sustaining the prudent economic policies, employing the surpluses for diversifying the productive base, and broadening the distribution of the benefits of development for the entire population.

Since the 1987 Article IV consultation with Botswana (EBM/87/69, 5/6/87), the performance of the economy has turned out to be better than anticipated. Over recent years Botswana had accumulated large diamond stocks owing to the slump in the diamond market, but following the sharp recovery in diamond prices Botswana sold a large diamond stock in July 1987 of about 1 billion pula, equivalent to one third of annual GDP. Thus, in 1987/88 real GDP growth jumped to 40 percent from 14.7 percent in the previous year, but it is estimated that in the absence of the diamond stockpile sale GDP would still have increased by 8 percent--a respectable growth rate by international standards. In this regard it is important for Directors to note the important role played by sound economic management, as confirmed by recent economic performance over the last three years when the GDP annual growth rate averaged 12.3 percent despite the drought conditions and the generally uncertain external environment. The budgetary surplus, which was recorded at 13 percent of GDP in 1987/88, led to a considerable buildup of bank deposits, which are being well utilized for development. At the same time, in 1987 the external current account surplus reached 27 percent of GDP, leading to a record overall balance of payments surplus of SDR 439 million and reserve accumulation equivalent to 26 months of imports.

On the domestic production front, the authorities recognize that the diamond sector is now producing at close to capacity level and no dramatic price developments are foreseen. Indeed, notwithstanding a relatively high per capita income, estimated at SDR 997 in 1986, its distribution is highly skewed as production is concentrated in mining, which generates more than 44 percent of GDP and over 80 percent of exports. GDP from the agricultural sector, equivalent to 3 percent of total output, is the primary source of livelihood for 80 percent of the population. In the meantime, unemployment, which has remained high--at about 25 percent of the unskilled labor force--owing to the capital intensity of mining and manufacturing, is rising fast. The authorities are therefore confronted with two major problems: The first is the diversification of the production base, while the second is the broad distribution of the benefits of a mineral-based economy.

With regard to diversification, the Government has attached high priority to rural development. However, in this connection, it is important to realize that a large proportion of the country is under desert conditions while the rest is vulnerable to recurring droughts, which have diminished production since the beginning of the decade. It is only this year that good weather returned to Botswana and helped bring crop production back to predrought levels. Therefore, for the remainder of the sixth Five-Year Development Plan (1985-91) and into the first half of the seventh Plan, the Government is investing heavily in water development. One major study has confirmed that water resources available in the northern parts of the country could provide enough supply for southeast Botswana in the medium to long term, as projected demand in this area will outstrip supply by 1994/95. However, water transfer from the Francistown region will be costly, calling for investment outlays of P 800 million to P 1,000 million. The Government is therefore examining carefully the spatial distribution of activities and population in the countryside.

Rural development is also being promoted by the Government through producer price incentives and grants to small farmers for the purchase of animals and implements under various schemes. In addition, the Government is actively supporting agricultural credit guarantee schemes and debt relief, especially in consideration of drought-stricken farmers. In this regard, the Government is recording some success in the north-east of the country--Pandamatenga--where government financial assistance has facilitated commercial farming. Under the scheme, the first two grain harvests have accounted for one third to one half of the Botswana Agricultural Marketing Board's intake.

The authorities are aware that the main potential source of export diversification lies in the manufacturing sector. Accordingly, they are encouraging private sector domestic and external investment through the provision of medium- to long-term credit. For example, under a new facility available initially for seven years, the United States' Agency for International Development in agreement with the Government, will guarantee 50 percent of loans of up to $3 million for some private enterprises. In addition to financial assistance, the Government is undertaking training of businessmen, while in the Ministry of Trade and Commerce there is a one-stop source of information and advice for potential investors. It is the Government's policy to encourage labor-intensive, small and medium-size private sector enterprises so as to arrest the unemployment problem. To this end, the Government has stepped up vocational education and apprenticeship programs.

The Government is providing serviced land for industrial and commercial use to eliminate bottlenecks for private sector investment under the ongoing Development Plan (1985-91). Further export diversification will be achieved when the production of soda ash commences under a new major project about to be finalized by the Government for exploiting large soda ash deposits at Sua Pan, where production is expected to start in 1991. Under this project the Government will provide infrastructure, notably the construction of the township, a railway, and power lines, while the exploiting company will pay economic rates to the Government for the use of infrastructure.

Fiscal policy has been designed to apply the budgetary surplus to lay down the foundation for the country's long-term development while holding down the rate of growth of current expenditure well below that of capital expenditure. In the meantime, budgetary developments in 1988/89 have turned out to be better than expected when the budget estimates were announced in February. This was mainly due to an increase of 13.5 percent in diamond prices in U.S. dollar terms effective in April, following a 10 percent increase in October 1987, both of which were applicable retroactively to the stockpile sale that took place in July 1987. Accordingly, in July 1988 the Government passed a supplementary budget whose main effect was to raise capital expenditure, which in 1988/89 is expected to increase by 46 percent compared with last year's outturn.

Another major goal of government fiscal policy is to diversify the revenue base away from the excessive reliance on external sector taxes but without adding significantly to the tax burden at this time. It has therefore started on this course gradually with the introduction this year of a 10 percent general sales tax on a few luxury goods. The budgetary surplus in 1988/89 is expected to rise to 16 percent of GDP from 13 percent in the last fiscal year. For the medium term, the Government will accelerate its capital expenditure program from 22 percent of GDP in 1988/89 to 25 percent in 1991/92. The government strategy is to embark on infrastructure and construction programs that will not have recurring costs to the Government once completed while overcoming bottlenecks for private sector development. Fully aware of the fact that diamond reserves are not inexhaustible, the long-term objective is to phase out the public sector progressively in economic transactions while promoting the role of the private sector.

The banking system in Botswana has progressively become more liquid, as the ratio of actual to required liquid assets increased from 4.67 in 1985 to 6.89 in June 1988. To a considerable extent, this reflects limited investment opportunities and the modus operandi of the commercial banks geared to short-term credit. While the Government's rising deposits have accounted for a large proportion of the liquidity, the parastatals have met most of their financial requirements by borrowing from the Government. Private sector credit demand has remained weak.

The Government has therefore taken a number of measures to encourage increased lending while deregulating interest rates in the last year. In March 1988 restrictions on borrowing by foreign-controlled firms were liberalized and the ceiling on the banks' exposure to a borrower was raised. At the same time, registered pension funds and life insurance companies were allowed to invest a higher proportion of their long-term assets in overseas stock exchanges up to a limit of 50 percent of assets from a previous limit of 25 percent. The Government intends to reverse this policy once investment opportunities in the country have increased. The authorities believe that these measures for supporting medium-term credit for industry, together with those government initiatives discussed above, will enhance domestic credit to the private sector. However, they are actively considering the development of other appropriate ideas and instruments for rolling over short-term credit to serve the medium-term to long-term financial requirements of the private sector.

The Botswana authorities are ever-conscious of the political and economic uncertainties prevailing in the region in addition to drought. In this connection, it is government policy to discourage external borrowing while encouraging the raising of funds from domestic sources; indeed this is one reason why the Government lends its own funds to parastatals. They intend to continue the pursuit of a cautious external borrowing policy, which has led to the steady reduction of external debt service ratio to 3 percent in 1987.

The authorities have pursued a flexible exchange rate as an active policy instrument for attaining the balance of payments goal and containing inflation. They constantly review the weight of the rand in the basket as well as the overall real effective exchange rate of the pula.

Early this year the authorities have further liberalized the exchange control system, which was already very open; as noted in the staff report, Botswana's system is one of the most liberal on the African continent. Nevertheless, for the time being, the authorities have preferred to continue with the transitional arrangements of Article XIV in view of the uncertainties related to political developments in Southern Africa and other exogenous factors.

Mr. Enoch made the following statement:

The Botswana economy has continued to perform well over the last year, owing largely to a combination of favorable trends in the diamond market as well as prudent domestic economic policies. The economy resembles more that of some low-absorbing, oil-producing economies than that of many of its neighbors, in that a single, exhaustible commodity--namely, diamonds--accounts for 85 percent of exports, and in that, with domestic absorption held in check, reserves continue to build up rapidly, having risen to over two years' worth of imports.

Two of the principal economic tasks in such an economy are the proper management of external reserves, including their use in the acquisition of external assets, and progress domestically to reduce dependence on the dominant export. Botswana has over the years invested its reserves prudently; as regards external assets, Botswana's use this year of its diamond stockpile to invest in de Beers was imaginative, although one wonders how far this investment advances the important objectives of sector and regional diversification.

As far as domestic economic diversification is concerned, progress has rightly been cautious. Botswana is prudently avoiding the use of its present external surpluses to seek too rapidly to develop sectors that are not economic. Although significant progress in the beef, textile, and tourist sectors can be expected, the scope for a rapid buildup of other sectors seems limited at present. The authorities are therefore right to concentrate on developing the infrastructure needed to sustain a more diversified economic base in the 1990s, when the diamond market may be less favorable but the regional situation--in particular, the possible opening of alternative overland transport routes--is somewhat easier. In this context, the proposed expenditure of significant public subsidies on the housing sector would not appear to be the most productive use of these resources.

The authorities are clearly correct to see the private sector as the appropriate vehicle for achieving economic diversification. While there is some risk that excessive public sector investment will crowd out private capital formation, a perhaps even more serious constraint may be the shortage of skilled labor. It is therefore appropriate that secondary education and the apprenticeship system are being developed; and perhaps as important is the agreement by the public sector to limit its recruitment of university graduates. It seems, however, that the recruitment limit of no more than one third of graduates each to the central and local government is insufficiently tight, especially as the remaining one third of graduates are presumably divided between the parastatals and the private sector.

Although the financial sector's interaction with the private sector remains underdeveloped, significant progress had been made in this area. The decisions in July 1988 to raise thresholds on bank deposits, to abolish ceilings on lending, and to lengthen the deposit maturity structure should allow more flexibility for the banks to lend for a longer period, and are therefore welcome. Foreign investors could also help provide the impetus needed by the private sector; however, as the staff report notes, significant barriers still exist which inhibit direct involvement by foreign firms, and I would urge the authorities to consider seriously ameliorating these barriers.

The staff report also notes that exchange rate guarantees remain in place for the parastatals. As other countries have found, and as the Botswana authorities are themselves doubtless discovering, such guarantees can be expensive, and they certainly misallocate resources. I endorse the staff's recommendation not to approve the multiple currency practice that results from these guarantees, and I urge the authorities to drop them as soon as possible.

I can support the proposed decision, but with slight disappointment. Last year this chair urged that Botswana consider adopting Article VIII status, and it was agreed at that time that discussion of this subject would be a part of this year's consultation. The Fund has made useful progress this year in seeing some other countries avail themselves of Article VIII status--for example, Indonesia and Korea--and it is unfortunate that the Botswana authorities are not yet prepared to join them. I would be interested to hear the staff's comments on prospects for progress in this area in the near future.

Finally, this chair also suggested last year that Botswana should be put on the bicyclic procedure, and the summing up of the Board's discussion on the 1987 Article IV consultation noted that this issue would be discussed at the forthcoming Annual Meetings. The staff report, however, recommends continuation of the 12-month cycle; I would be interested in the rationale underlying this recommendation. I hope the authorities do not perceive a change in the consultation cycle as a lack of interest on the part of the Fund: indeed, the repeated suggestion that Botswana should consider the bi-cycle reflects the Fund's recognition of the strength of the economy and confidence in the authorities' ability and commitment to continue to manage it well.

Mr. Morita observed that the authorities' judicious policy management under favorable economic circumstances had brought about remarkable progress in Botswana in the past year. However, the economy was still heavily dependent on the diamond mining sector, and the authorities should continue to make an effort to broaden the economic base and take advantage of the favorable economic environment before the revenues derived from diamond products abated. The authorities had clearly recognized that need and had launched an effort to diversify the productive base and vitalize the private sector, while maintaining a prudent macroeconomic policy. He strongly supported the authorities' objectives.

With regard to specific policy issues, he had only two comments to add to the well-elaborated staff appraisal, Mr. Morita remarked. First, a cautionary note was required on the pace of the implementation and magnitude of the public investment program. The program could be well supported by government resources, but the economy's absorptive capacity seemed to be limited, and the financial market was still not highly developed. Thus, too rapid an implementation of the program might lead to higher inflation and exchange rate appreciation, or increase distortions in the economy.

Second, civil service salaries should be monitored closely, Mr. Morita continued. Also, the staff report indicated that minimum wages in the construction and manufacturing sectors had been rising annually at about the same pace as the cost of living index. While that was not a serious issue at the present stage, wage policies should not be a disincentive to the expansion of the labor-intensive private sector. That was also an important consideration for maintaining the international competitiveness of industry, because Botswana's per capita income was high compared with that of other sub-Saharan countries. Furthermore, the authorities should continue to intensify their efforts to tackle the "dualistic" labor market--namely, the coexistence of a market having an urban, relatively organized industrial labor force with a large market having primarily an informal, rural force that was more flexible. He supported the proposed decision.

Mr. Kpetigo said that although government revenues remained sound, the authorities had to be cautious in the management of Botswana's resources, because the prospects for the growth of diamond exports were not heartening. Since he was in broad agreement with the staff's assessment, he had only some brief comments.

Owing to its strong financial position, Botswana had significantly raised development spending, which was expected to decline in real terms during the first half of the 1990s, so as to allow private investment to play a crucial role in the country's economic growth, Mr. Kpetigo observed. The authorities' efforts to diversify the economy through the creation of a number of self-liquidating and self-supporting projects, and to develop and strengthen the private sector were welcome. However, further actions were needed with a view to expanding the agricultural sector as well as the physical infrastructure and industry, and to help pave the way for an efficient economic reform process.

It was hoped that the measures to encourage increased lending by the banks would succeed effectively to reverse Botswana's relatively underdeveloped financial system, which was dominated by a few large sectors, Mr. Kpetigo commented. The move toward measures designed to liberalize transfers was commendable; the authorities should persist in their efforts to liberalize the foreign exchange system.

Botswana's economic performance thus far had been impressive, Mr. Kpetigo concluded. He could endorse the proposed decision.

Mr. Hogeweg observed that the discussion in the staff report on exchange rate policy was somewhat confusing. For instance, on page 5, favorable terms of trade effects coming from the exchange rate were mentioned, whereas on pages 13 and 41, a real exchange rate depreciation parallel to the downward course of the South African rand was stressed. Moreover, at various points in the staff report, mention had been made of the need to apply a flexible exchange rate policy in order to maintain competitiveness. In view of Botswana's strong external and reserve positions, what was the basis for the staff's recommendation for flexibility in exchange rate management?

The staff representative from the African Department remarked that the central issue with respect to the exchange rate was Botswana's ability to diversify the economy. That issue had been stressed in discussions with the authorities, but the staff had not concluded that the rate needed to be adjusted at this time. The staff considered that, first, cost indices needed to be developed. To date, the authorities had looked only at the relative movements in South African price indices and the Botswana cost of living index; these were not comparable. The real issue was the competitiveness of Botswana's production cost structure vis-à-vis neighboring countries and its potential for expanding into areas other than diamonds. In that sense, the staff had stressed the need for flexibility and for improving the measures of competitiveness. By simply following the rand, the authorities had tended to ignore Botswana's competitiveness vis-à-vis other export markets that experience suggested were likely to have more potential.

The favorable terms of trade effect vis-à-vis the rand was attributable to the fact that a large share of Botswana's imports came from South Africa while its exports were denominated in U.S. dollars, the staff representative explained. The large swings in the value of the rand vis-à-vis the dollar resulted in terms of trade effects that worked in different ways at various times during the period.

The staff had also discussed at length, and had encouraged, Botswana's adopting Article VIII status, the staff representative commented. The Governor for Botswana had stressed two points in that regard. First, Botswana's system was extremely liberal; in practice, it approximated Article VIII status. Second, it was desirable to retain Botswana's Article XIV status because of concerns about regional uncertainties and the feeling that at some stage it might be necessary to introduce restrictions quickly and flexibly.

At the final meeting with representatives of both the Central Bank and the Ministry of Finance, it was evident that, while the Central Bank favored the bicyclic procedure for Botswana, the Ministry preferred an annual cycle because it provided them with an independent review of the Central Bank's activities each year, the staff representative from the African Department remarked. As a compromise, the authorities suggested an 18-month cycle. When the staff explained that that was not possible, the authorities said that they would like to remain on the 12-month cycle, but they would not mind if the consultation was delayed by a few months.

The staff representative from the Exchange and Trade Relations Department, responding to a question by Mr. Ismael, confirmed that the staff had explained to the authorities that there was actually no difference between a de facto and a de jure liberal foreign exchange system and that under Article VIII status, they could, in an emergency, introduce restrictions subject to the approval of the Board. The key issue in that regard was that any restriction, whether adopted in the event of an emergency or not, would be subject to Article VIII. Moreover, whenever such restrictions or any other Article VIII restrictions, such as a multiple currency practice, became effective, the member had to indicate the special circumstances in which they became effective and the plan for dismantling them so that they could be considered temporary in nature.

Mr. El Kogali remarked that he wished to stress that the authorities had further liberalized the exchange control system, which was already one of the most liberal in Africa. Nevertheless, for the time being, the authorities preferred to continue with the transitional arrangements under Article XIV in view of uncertainties relating to political developments in southern Africa. More generally, he was grateful for the interest Directors had shown in Botswana, and he would convey Directors' comments to his authorities.

The Acting Chairman made the following summing up:

Directors observed that Botswana's economy had continued to register an impressive performance characterized by rapid growth, relatively low inflation, and a strong balance of payments and reserve position. Directors emphasized that while favorable developments in the diamond sector have played a key role, the authorities' success in maintaining an open economy and a stable macroeconomic environment has contributed importantly to that performance.

Directors considered that Botswana was at an important juncture, with export receipts and government revenues from the diamond sector expected to slow sharply over the medium term. The large resources presently available to Botswana would need to be used wisely in order to promote a broad-based development of the economy and a rapid expansion of employment opportunities. Directors concurred with the authorities' assessment that the private sector should provide the engine for future growth and that such growth must be export led. This underscored the need to maintain Botswana's competitiveness. To that effect, cautious wage and incomes policies would be required. It was also suggested that investment would be facilitated by prompt action to streamline and coordinate permit and licensing procedures.

Directors noted with approval the authorities' record of restraint in government spending, the priority given to investment, and the insistence on economically sound projects. Directors were in broad agreement with the authorities' medium-term strategy, particularly the emphasis on projects that would be self-liquidating, or at least self-supporting, and which would remove bottlenecks to private sector development. They were concerned, however, that too rapid an expansion in public sector investment could crowd out the private sector in terms of access to skilled labor and certain other inputs. Developments in this area would need to be monitored carefully, and the Government's investment program might have to be scaled back.

Directors welcomed recent steps toward deregulating and increasing competition in the financial system and strongly commended the authorities for the recent measures that had resulted in a further substantial liberalization of Botswana's already open trade and payments system. With reference to the exchange rate guarantees provided by the Government on external borrowing by parastatals, Directors encouraged the authorities to eliminate the features of this scheme that give rise to a multiple currency practice. Botswana was again urged to accept the obligations of Article VIII at an early stage.

It is expected that the next Article IV consultation with Botswana will be held on the standard 12-month cycle, although some flexibility might be incorporated in the exact timing of the consultation.

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Botswana's exchange measures subject to Article VIII, Sections 2(a) and 3, in concluding the 1988 Article XIV consultation with Botswana and in the light of the 1988 Article IV consultation with Botswana conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Botswana continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions except for the relatively liberal limits on tourist and business travel and remittances abroad that are maintained by Botswana in accordance with transitional arrangements under Article XIV, Section 2, and the multiple currency practice arising from the foreign exchange risk-sharing scheme applicable to borrowing by parastatal organizations, which is subject to Fund approval under Article VIII, Sections 2(a) and 3. The Fund encourages Botswana to remove this multiple currency practice as soon as possible.

Decision No. 9021-(88/168), adopted
November 18, 1988

4. VIET NAM - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY - POSTPONEMENT

Without discussion, Executive Directors agreed to a request by an Executive Director to postpone until December 7, 1988 consideration of the further review of Viet Nam's overdue financial obligations to the Fund following the declaration of Viet Nam's ineligibility to use the general resources of the Fund.

The decision was:

Paragraph 4 of Executive Board Decision No. 8962-(88/127), adopted August 25, 1988, shall be amended by substituting "no later than December 7, 1988" for "within three months from the date of this decision...."

Decision No. 9022-(88/168), adopted November 18, 1988

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/167 (11/14/88) and EBM/88/168 (11/18/88).

5. SUDAN - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY - POSTPONEMENT

Paragraph 4 of Decision No. 8964-(88/129), adopted August 26, 1988, shall be amended by substituting "no later than December 12, 1988" for "within a period of three months from the date of this decision."

Decision No. 9023-(88/168), adopted November 14, 1988

6. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/88/280 (11/14/88).

Adopted November 17, 1988

7. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 88/40 through 88/42 are approved. (EBD/88/316, 11/8/88)

Adopted November 14, 1988

b. The minutes of Executive Board Meetings 88/43 through 88/47 are approved. (EBD/88/321, 11/9/88)

Adopted November 15, 1988

c. The minutes of Executive Board Meetings 88/48 through 88/50 are approved. (EBD/88/322, 11/10/88)

Adopted November 16, 1988

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/276 (11/11/88) is approved.

APPROVED: May 17, 1989

LEO VAN HOUTVEN
Secretary