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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/149

3:00 p.m., October 26, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
	W. K. Parmena, Temporary
	Jiang H.
	M. K. Bush
	E. L. Walker, Temporary
J. de Groote	
	M. Hepp, Temporary
	R. Morales, Temporary
	A. M. Othman
	B. Goos
	J. Reddy
A. Kafka	J. Hospedales
	M. Foot
	D. McCormack
	G. D. Hodgson, Temporary
	K. Yao, Temporary
Y. A. Nimatallah	
	L. Filardo
	M. Fogelholm
	D. Marcel
	G. P. J. Hogeweg
	C.-Y. Lim
	O. Kabbaj
	S. Rouai, Temporary
A. K. Sengupta	L. E. N. Fernando
	M. Sugita
S. Zecchini	

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

Also Present

Exchange and Trade Relations Department: S. Kanesa-Thasan. External Relations Department: B. J. Mauprivez. Fiscal Affairs Department: F. C. Ribe. Legal Department: F. P. Gianviti, General Counsel; T. M. C. Asser, P. L. Francotte, R. H. Munzberg, J. K. Oh. Secretary's Department: C. Brachet, Deputy Secretary. Treasurer's Department: F. G. Laske, Treasurer; D. Williams, Deputy Treasurer; J. E. Blalock, B. E. Keuppens, G. Wittich. Western Hemisphere Department: J. Ferrán, Deputy Director; J. Clark, A. Elson. Office of the Managing Director: R. Noë, Internal Auditor; C. P. McCoy, R. H. Ronneberg. Advisors to Executive Directors: M. B. Chatah, P. D. Péroz, G. Pineau, I. Puro, A. Vasudevan. Assistants to Executive Directors: F. E. R. Alfiler, J. R. N. Almeida, F. Di Mauro, S. Guribye, G. K. Hodges, S. King, K.-H. Kleine, K. Kpetigo, V. K. Malhotra, T. Morita, D. V. Nhien, C. Noriega, L. M. Piantini, G. Seyler, H. van der Burg.

1. SPECIAL CONTINGENT ACCOUNT - OPERATIONAL MODALITIES

The Executive Directors continued from the previous meeting (EBM/87/148, 10/26/87) their consideration of a staff paper on the Fund's reserves and operational modalities of the Special Contingent Account (EBS/87/178, 8/11/87).

Mr. Goos remarked that while there was no urgent need to settle the technical issues of the Special Contingent Account's modalities, a discussion of the more general problem would be useful. While the decision by which the Account was established linked its existence to the persistence of arrears, a more flexible formula, along the lines of the rules established for the distribution of supplemental income would be desirable. A reformulation of the decision would probably be the most appropriate course of action, given the definitive wording. The words "when the need for this Account disappears" could be replaced by a more precise formulation, reading "when there are no outstanding overdue obligations or at such earlier time as the Fund may decide." The amount placed to the Account should be distributed only to those debtors that had paid charges to the General Resource Account in fiscal year 1987, as set out on page 6 of the staff paper.

The deterioration in important reserve ratios in the Fund, most notably with respect to arrears and to credit outstanding to members with protracted overdue obligations, was cause for concern, Mr. Goos said. That development meant that the safeguarding of the Fund's financial position should be re-examined, with proposals to be brought forth at the forthcoming midterm review. While some speakers had suggested that additional amounts be channeled to the Account, he remained skeptical about the appropriateness of introducing provisioning or adding to the Special Contingent Account, for reasons repeatedly set forth in the past. However, that position could be reviewed in light of further examination of the issue and specific proposals, including precise indications of whether the potential losses that were perceived by the proponents of provisioning could in fact be met through higher charges and/or lower remuneration. There was a clear need for specific proposals in terms of the amount by which reserves or provisions should be built up, and how those figures translated into increases in charges or reductions in remuneration. In sum, there should be a concentration on the financing aspect of further protective measures.

Mr. Sugita said that he agreed with the staff's interpretation of the conditions for the dissolution of the Account, and with Mr. Goos's proposal to modify the decision in that respect.

On the distribution of the amounts in the Account at the time of dissolution, the original intention of the Board decision had been to distribute the amount equally to creditors and debtors of FY 1987, Mr. Sugita said. He could accept that decision. He had not been in favor of establishing the Account in the first place, preferring an outright increase in reserves which would not be distributed in any way.

However, given the establishment of that Account, the Board could as easily have decided that the balance in the Account be distributed exclusively to debtors of FY 1987, since accurate estimates of the income position for that year would have resulted in a lower basic rate of charge. Therefore, he would not object to a new decision in favor of distributing only to debtors if the majority of the Board supported it.

On future additions to the Account, all the relevant factors should be taken into consideration, including the prospects of Fund income positions and the trend of arrears, Mr. Sugita concluded. It would therefore be preferable to discuss that question at a later stage. However, simplicity and transparency of the scheme were indeed elements to be strived for.

Mr. El Kogali made the following statement:

As pointed out in the staff papers, the Fund reserves and the Special Contingent Account play essentially three roles. Perhaps the least important in recent years, in practical terms, has been their contribution to the Fund's liquidity. The second role, of demonstrating to the financial world that the Fund is managed prudently, is closely related to the more important role of protecting the Fund's subscribed assets from impairment. This impairment can arise principally from losses resulting from excess of annual expenditures over income. As illustrated in the table on page 27 of the staff paper, the Fund suffered operational deficits from 1974 to 1977 and again in 1985. Fund reserves played a useful role in cushioning Fund income during these years.

In order to help the Board reach a judgment on the adequacy of Fund reserves for the above purposes, the staff has employed some comparisons with other cooperative financial institutions. While the importance of prudent financial management cannot be overemphasized, it must be stressed, however, that these other institutions are more reliant on favorable ratios as they raise funds from private capital markets, which is not the case for the Fund. The table on page 31 thus shows that while the ratio of reserves to outstanding loans in 1986 was 3.2 percent for the Fund, it was 8.5 percent for the World Bank, 19.5 percent for the African Development Bank, 25.8 percent for the Bank for International Settlements, and 46.7 percent for the Inter-American Development Bank. Obviously, the Fund ratio would have been substantially higher if the reserve holdings of Fund gold were valued at market rates rather than at SDR 35 per ounce. May I add also that a better comparison might have been a ratio of reserves to borrowed resources for the Fund relative to other institutions. In this respect, I would appreciate staff comments.

It has been stressed on several occasions in Board discussions of this subject that the Fund is a unique institution and that, therefore, the comparison with other intergovernmental cooperative financial institutions, while important, should not be overstretched. In this respect, it has been pointed out by the Legal Department, for example, that the Fund does not extend credit but undertakes purchase and repurchase transactions so that at any time its holdings of currencies of member countries are equal in value to the purchases outstanding; a default can only arise in a case of a member's repudiation of its obligations and withdrawal from the Fund. Nevertheless, as the External Audit Committee (EAC) has noted in its 1987 recommendations to the Treasurer on page 35 of the report, "the scale and duration of overdue obligations suggests that the effective realizable value of certain of the Fund's assets, represented by overdue repurchase obligations, may have been impaired." The Committee thus recommends that increasing amounts be placed in the Special Contingent Account in the event that settlement of protracted arrears is expected to be delayed further.

The rapid growth of the problem of overdue obligations has led to the increase in the reserve target from 3 percent to 5 percent in 1985 and further to 7.5 percent for FY 1987 and FY 1988. As the staff has shown, in FY 1987 the combined effect of a reserve target and the Special Contingent Account is a de facto increase in reserves by 18 percent. Yet, as Mr. Sengupta illustrated this morning, the absolute level of the Special Contingent Account, which is earmarked to protect the arrears, is far too small relative to these arrears to provide for effective protection. A more pragmatic solution would be for the creditors to assist the few members with protracted arrears more directly. In the meantime, this chair considers it desirable to keep the Fund's target income separate from the proceeds of this Account so as to maintain the flexibility inherent in the latter.

Let me now turn to more specific questions raised by the staff. It is clear from my above comments that the problem of overdue obligations has not disappeared and therefore the time for the distribution of the amount placed in that Account in FY 1987 has not come. But in this regard I would favor a ruling which would adhere to the spirit of the decision that set up the Account in the first place. In other words, upon the dissolution of the Account the proceeds should be distributed to debtors for FY 1987 who paid the high rate of charge that generated the income in excess of net target income.

Mr. Jiang recalled that in view of the existing overdue obligations, the Board, after failing to reach an agreement on provisioning, had compromised and established a Special Contingent Account into which SDR 26.5 million was placed. Beginning in 1985, the Board had increased the net income target of the Fund from 3 percent of reserves to 5 percent, then to 7.5 percent for FY 1987 and FY 1988. Since that time, the Fund's reserves had increased by about 18 percent, and the reserve position of the Fund was obviously more favorable at present. Given that increase, it might be appropriate to return to a 5 percent or a 3 percent net income target for FY 1989. As to the appropriate time for dissolution of the Special Contingent Account, the same criteria as those proposed when the Account was established should hold. When the Account was no longer necessary, the SDR 26.5 million should be distributed among the Fund's FY 1987 debtors as that amount had been contributed by them through a higher than necessary rate of charge. In any event, the creditors had made no contribution to the Account.

Mrs. Hepp said that she agreed with the staff on the circumstances under which the Special Contingent Account would be considered no longer necessary, and with Mr. Goos's position on that point. The amounts placed in the Account should be distributed to the debtors, who had paid higher than necessary charges on ordinary resources to generate the achieved higher net income.

Mr. Lim said that the staff paper covered two main issues on which a decision was required, and raised, in a preliminary fashion, several issues that would have to be addressed at the time of the next income review. The two main issues for decision were the circumstances in which the need for the Special Contingent Account might be considered to have disappeared, and how the amount placed into the Account in FY 1987 should be distributed, should the Account be terminated.

It would appear reasonable for termination of the Account to occur when the arrears problem had declined substantially, rather than when there were no longer any arrears whatsoever, Mr. Lim indicated. Flexibility on that aspect seemed justified. However, the appropriate distribution of the amount if the Account were terminated was less clear cut. The Australian authorities preferred that it be distributed in equal parts to debtors and creditors, in accordance with the principles of burden sharing. However, some members of the constituency had indicated their sympathy for the alternative option of distributing the amount only to debtors.

Decisions on possible future additions to the Account--and their distribution--should await the next income review, and a full update on the arrears situation, Mr. Lim remarked. As a preliminary suggestion, the size of future contributions could, perhaps, reflect the total obligations to the Fund of those members with arrears outstanding for more than two years. The 1987 or 1988 contributions could form a benchmark around which future contributions could be varied depending on changes in the magnitude of the arrears problem.

Mrs. Filardo made the following statement:

During our last discussion on the Fund's income position for financial years 1987 and 1988, a compromise solution was reached regarding the creation of a contingent account in substitution for provisioning, to strengthen the protection of Fund assets, given the amount of overdue obligations to the Fund. On that occasion, as well as on many others, this chair stated that the problem of arrears to the Fund constitutes part of a large problem in that developing countries have not received appropriate financial assistance to overcome the burden of debt and economic problems in spite of the adjustment programs they have implemented.

The tightness of liquidity has implied a situation in which arrears are accumulating to developing countries' creditors and, in particular, to the Fund. In this regard, and until we reach a more permanent solution to this problem, I think that we have agreed to take steps to preserve the sound financial management of the Fund. Among the measures already taken, we welcome the increase in income to 7.5 percent of reserves for FY 1987 and 1988; the addition to reserve income in excess of the targeted amount; the decision to no longer accrue as current income the charges from members that are overdue for six months or more; the special charges on overdue obligations; the tightening of the timing of procedures for dealing with such arrears; the periodic evaluation of the financial position of those members with protracted overdue obligations, and, finally, the creation of a contingent account.

The agreement to establish the Account was reached as a compromise solution, in the spirit of serving the purpose of strengthening the financial position of the Fund, without being deemed as provisioning in the strict sense. We have considered that provisioning as such should be avoided because it would impair the members' creditworthiness, whereas the role of the Fund is to contribute to improving it.

In the decision, it was also stipulated that when the need for the Account disappears, the amount shall be distributed among creditors and debtors for the year, in accordance with the principles of burden sharing. However, it would be necessary for the Board to return to the issue to determine the specific operational details of the Account.

It is clear that the Account was created as a result of the existing overdue obligations, and its cancellation would depend on the elimination of the essential purpose for which it was created. According to the staff paper, the question remains as to what will be the method of distributing the amount placed in the Account and when that will take place. It is not clear to me why this discussion is taking place, as the decision adopted on June 17 already specifies the mechanism of distribution in accordance with the principles of burden sharing. Nevertheless, if the subject has to be reopened, there is no doubt that the amount should be distributed among debtor member countries.

Finally, my impression is that what we should have been discussing today are the next steps to follow. Since those steps have not been proposed by the staff, we would prefer to have a thorough discussion of the matter in the forthcoming income review.

Mr. Kabbaj considered the scope of the current meeting to be limited to discussion of the Special Contingent Account. The more general problem of provisioning should be considered on the basis of a staff paper outlining the remaining problems to be tackled.

The problem of overdue obligations was disconcerting, and the cooperative nature of the Fund and the revolving character of its resources were of utmost importance in that context, Mr. Kabbaj remarked. While the amount of arrears to the Fund had sharply increased, the problem was concentrated on a small number of countries. With the exception of one or two of them, those countries would not be in a position, in the forseeable future, to discharge their obligations even if they implemented the most stringent adjustment program. Without the participation of creditors and donors, the overdue problem could not be solved. In any case, it was unfair to think that it could be solved by increasing charges for those debtors that punctually discharged their obligations to the Fund.

The system of setting charges along with many other features of the system, was heavily biased against debtors, and should be reviewed, Mr. Kabbaj said. The system of burden sharing was heavily weighted in favor of creditors. The staff should give consideration to the issue of burden sharing in future papers on such issues as the Fund's income, the lenthy discussions of which had their origin in the nature of the system.

The need for the Special Contingent Account might be considered to have disappeared when the problem of overdue obligations was essentially solved, and the amount to be distributed upon the Account's dissolution should be returned to those who had paid higher than warranted charges under the income target in FY 1987, Mr. Kabbaj agreed.

Mr. Hodgson said that in the working of the Special Contingent Account, the Fund should continue to be guided to the fullest extent possible by the principles of burden sharing, which it had established for dealing with the broad issue of overdue obligations. Some element of judgment would be needed in deciding when the arrears problem was solved, but full settlement of overdue obligations should be in prospect at the time that the Account was dissolved. His authorities had a preference for equal distribution of the SDR 26.5 million between creditors and debtors since, as mentioned in the staff paper, resources could not be attributed unambiguously to any one source. However, that was a rather arbitrary choice, as would be a decision to give the entire amount to debtors. Therefore, it was preferable to leave that issue open, to be considered in the context of further discussions. While he could not address the broader question of how the Account should proceed, he hoped that the staff could consider and set out some options, including those ideas raised by other Directors, which could be more fully discussed during the next meeting on the Fund's income position and overdue obligations.

Mr. Yao reminded Directors that at EBM/87/90, his chair had supported the creation of the Special Contingent Account because of the need to close the Fund's accounts. At that time, it had been the understanding of his chair that the income targets for fiscal years 1987 and 1988, as agreed upon under the principles of burden sharing, provided adequate safeguard against the risks associated with members' overdue obligations. Indeed, the staff paper indicated an improvement in the Fund's reserve position, both with respect to such indicators as outstanding credit and in comparison with the position of other international cooperative institutions.

The funds already placed in the Special Contingent Account should be used to reduce retroactively the rate of charge, Mr. Yao indicated. Therefore, that amount should be distributed to the debtors when the Account was dissolved. On the time when that would be appropriate, linking the dissolution of the Account to the elimination of overdue obligations technically transformed the Account into a provision, which was unacceptable to his chair. He supported Mr. Sengupta's recommendations on dealing with overdue obligations, which allocated a major role to donor countries.

The Treasurer said that while he could not give precise figures on the ratio between the Fund's reserve and its borrowed resources in comparison to that of other financial institutions, he would look further into that matter. In general, that ratio was much smaller in the Fund than in other institutions. In particular, it was considerably smaller than that for the World Bank, since the Fund was essentially a quota-based institution, whereas the Bank and other financial institutions expanded credit extension basically on borrowed money.

It was true, as many Directors had pointed out, that the problem of overdue repurchases was likely to continue, the Treasurer remarked. Since June, the incidence of protracted outstanding overdue repurchases had increased by about SDR 200 million, and it would continue to increase if those member countries with overdue repurchase obligations, on which complaints had been issued under the Rules, remained overdue. The staff would examine those questions in detail in preparation for the midterm review of the Fund's income position; it would also, in that context, deal with the many suggestions made by Directors during the current discussion.

The General Counsel, in response to Mr. Foot's question on how the Fund could use the Special Contingent Account when its status was so unclear and it was not yet known who would receive the proceeds of the account when it was dissolved, said that normally the identities of the creditors were determined when a liability was established. That had not been done in the case of the Special Contingent Account because the Fund's procedures were more flexible than most. However, a decision did have to be made: since the principle of a liability had been established, it was not possible to cancel that liability. For example, it would not be proper for the Fund to decide to transfer the proceeds of the Special Contingent Account to the reserves of the Fund, because that would mean that they would no longer be refundable, and refundability was an essential feature of the Account. There were two possible uses of the Account: first, to charge any possible loss to the Special Contingent Account; and second, if a loss did not materialize, to refund the proceeds to whomever was determined, among creditors and debtors, as the recipients of those proceeds.

It had been suggested by Mr. Nimatallah that a decision be taken at the current meeting, or at least before the end of 1987, to add the 2.5 percent increase in the net income target, resulting from the 1986 decision on burden sharing, to the Special Contingent Account at the end of 1987, the General Counsel recalled. Such a decision would be consistent with the decision on burden sharing, but two alternatives could be considered. Under the decision on burden sharing, the additional 2.5 percent in the net income target was burden shared, but not refundable. Therefore, a first alternative would be to add the 2.5 percent to the Account without the refundability feature, which would then create a different kind of special contingent account under that heading; it would be a nonrefundable amount. That decision could be taken by a majority of the votes cast; it could also be changed at the end of the year by the same majority, because a decision whether to place to the Special Contingent Account or to reserves required only a majority of the votes cast. A second, more complex, alternative would be to decide that the 2.5 percent be placed to the Account with the same refundability feature which currently applied. The refundability feature, which was not present in the decision on burden sharing, would become applicable to that 2.5 percent because of the decision on the Special Contingent Account. Because of that refundability feature, there would be a reduction in the rate of charge and, if part of the refund went to creditors, an increase in the rate of remuneration, either of which required 70 percent of the total voting power. A decision to add such a feature would result in a right for the beneficiaries to the reduction in the rate of charge or the increase in remuneration, and any subsequent change in that feature could not have a retroactive effect. Therefore, at the end of the current fiscal year it would not be possible to take away from the beneficiaries of the decision the vested right which had accrued to them under that decision.

Mr. Zecchini asked whether the principle that some vested interests could not be changed retroactively would apply to the suggestion to refund the amount to the debtors alone, given that the decision taken in June had mentioned both debtors and creditors as recipients.

The General Counsel said that once the right to the funds was established at the end of FY 1987, it could not be taken away by a further decision. However, it was not yet clear who the beneficiaries were.

Mr. Zecchini said that in the staff paper there were two options: either to share the refund among creditors and debtors, or to refund the debtors only. He wondered whether the second option was legally viable, based on the principle enunciated by the Director of the Legal Department.

The General Counsel indicated that the problem was one of interpreting the decision taken at the end of the 1986 financial year. At EBM/87/90, the Managing Director had said that "it is the understanding that the proceeds recorded in the Special Contingent Account shall be distributed to the creditors and debtors in accordance with the principles of burden sharing when the need for this account disappears." There had been no clear agreement on how a distribution would be made; some understood the reference to the principles of burden sharing as meaning there could be an equal distribution to creditors and debtors, and others interpreted it as meaning that the refund would be made on the basis of who had contributed to the Account. It appeared that the Executive Board had deliberately left the question ambiguous.

Mr. Zecchini felt that there could be legal objection to refunding the amount only to the debtors, unless the wording of the decision, which referred to both creditors and debtors, could be interpreted as meaning that debtors received 100 percent and creditors zero percent.

Mr. Nimatallah asked whether his proposals--to divert the 2 1/2 percent burden-shared increase in reserves to the Special Contingent Account, and to increase net income by another 2 1/2 percent burden shared, which would also be placed to the Account--could be implemented, and if so, whether they required a 70 percent majority of the total voting power.

The General Counsel confirmed that if Mr. Nimatallah wished to add to the Special Contingent Account with the refundability feature, then both of his proposals would require 70 percent of total voting power.

Mr. Chatah asked whether the establishment and termination of the Account required a qualified majority, or whether only the decision on the distribution mechanism required 70 percent of total voting power, with the termination of the Account being possible with a simple majority. Also, the June 17 decision had discussed a liability of SDR 26.5 million, whereas the amount remaining in the Account at the time of its termination might actually be less.

The General Counsel said that both the establishment and termination of the Account could be decided upon by a majority of the votes cast. It was because the Account was financed through the rate of charge--and possibly through the rate of remuneration--that 70 percent of the total voting power was required, and that a decision to allocate the resources would also require 70 percent of total voting power. On the second question, it was clear that the Special Contingent Account was a continued account, with no assurance that the full amount would be repaid, because there might be a loss which would be charged to that Account. There was a contingent liability to repay SDR 26.5 million.

Mr. Chatah questioned whether the decision allowed for such an interpretation, since it read "this amount shall be distributed when the need for this account disappears without any qualifications of this amount."

The Treasurer said that he confirmed the view of the General Counsel response that the Account had been established to protect the Fund from protracted overdue financial obligations. If it was decided that the Fund had suffered a loss from those overdue obligations, then that loss would be charged against the Special Contingent Account, and only if the loss surpassed what was available in the Contingent Account, would it be reflected in the Fund's operational costs. Once the Board came to a decision that the problem of arrears was no longer existent, then the amounts remaining after losses had actually been charged against the Account could be distributed to those who were to benefit from that Account. There was no assurance that the full amount placed into the Account would be redistributed at the time of the Account's dissolution.

Mr. Chatah considered that the decision was not clear enough, as it appeared to refer to the full SDR 26.5 million. Also, if losses were to be charged to that amount and to any future amount put into the Account, then the question arose of how to distribute the amount charged. While the Board might decide to return the full SDR 26.5 million to debtors, future augmentations might be redistributed in another way.

Mr. Sengupta asked whether the Treasurer, by stating that income losses would be charged against reserves, meant that there would have to be a method by which losses of assets could be estimated, and then charged against the Special Contingent Account. Otherwise, the Account would remain practically intact, until the Board had decided that the problem of arrears was solved, when the whole amount would be returned.

The Treasurer repeated that charges against the Account could only be made when the Board had decided that a loss had occurred. If that decision did not take place, the Account would remain intact until the time that the Board decided the problem of arrears was no longer in existence, and dissolution could take place.

Mr. Zecchini recalled that at EBM/87/90, the staff had indicated that technically the Fund did not incur a loss when a member became overdue to the Fund, as the Fund held the equivalent value of the purchase in the member's currency. Rather, overdue obligations simply affected the Fund's liquidity position. On the issue raised by Mr. Sengupta, the system of burden sharing had shielded the Fund effectively from potential losses of income, and therefore that issue was not at stake in the context of the Account.

Mr. Nimatallah asked whether, if it were decided that the SDR 26.5 million would eventually be returned to the debtors, and if amounts were subsequently contributed on a burden-sharing arrangement, to which amount would a probable loss be charged.

The Treasurer said that the total loss would be charged against the total amount in the Account. The question of attribution would arise and depending on the size of the loss and taking into account allocations to the account considered at the time. It was the accounting problem: first in, first out, or last in, first out.

The Acting Chairman then made the following summing up:

Let me draw the following general and specific conclusions from our useful discussion of today. First, the growing arrears to the Fund were of concern to all Directors. Second, a number of approaches to arrest and reverse that trend needed to be pursued simultaneously, including, for example, donor support of countries in arrears and undertaking comprehensive economic adjustments. Third, it remained the firm expectation that all members with overdue obligations would eventually clear their arrears. Fourth, in the meantime, and in light of the existing arrears, it was necessary to seek means to safeguard the Fund's financial position. Fifth, reserves were one method for protecting the Fund: Directors noted the increase in reserves that had been made, especially since 1985, but several Directors emphasized that the Fund's reserve position in relation to arrears had deteriorated.

In that connection, the Special Contingent Account was seen by most Directors as a special and pragmatic way to hold precautionary reserves. There was a clear desire to keep the operation of the account simple and transparent, while maintaining the principle of burden sharing.

Directors felt that the upcoming midyear income review would be an appropriate time to discuss further the general issues that should be addressed in the paper being prepared by the staff for that meeting. First, what criteria would be used in deciding whether to add to the Special Contingent Account? In that connection, some Directors wondered what criteria or factors would influence the consideration of whether additions should be made to the Fund's ordinary reserves or to the Special Contingent Account.

Also, what would be the sources of contribution if and when it were decided that an additional allocation to the Special Contingent Account should be made? Second, under which circumstances would the account be used, and what would be the modalities for making calls on it? Third, under what circumstances would the account be reduced or terminated and what would be the modalities for making that decision? Some Directors felt such decisions should be made on a judgmental basis, rather than according to an automatic rule, raising the question of whose judgment would be involved. Also, what criteria would be used in determining the distribution of the account's funds when they were returned to the contributors? The general principle of burden sharing was emphasized throughout the discussion.

Several Directors have indicated a preference not to take a decision now on the matter of the distribution of the amounts placed to the Special Contingent Account for FY 1987 once the account is no longer needed; such a decision would require 70 percent of the total voting power. It would be desirable for the Board to work toward a decision on the many issues involved when it undertakes the midyear review of the Fund's income position, in December.

Mr. Kabbaj recalled that he had raised the point that the present system of setting charges, which was based on a target income of 7.5 percent of the Fund's reserves, with the 2.5 percentage points above 5 percent being burden shared, was unfair to debtors because there was a floor on the remuneration coefficient, but no limit on charges. The operation of that system meant that in the previous year, creditors had contributed 12 percent of the target income, and debtors, 87.5 percent. While it was not necessary to set a 50/50 proportion or a quota-based system, the staff should pay attention to the inconsistencies in burden sharing. The SDR 26.5 million contributed to the Special Contingent Account was clearly debtor related, but at the present meeting many speakers had claimed that, since the amount had been burden shared, it was unclear who had actually contributed to that amount.

Mr. Sengupta said that he had discerned overwhelming support for distributing the SDR 26.5 million to debtors, and asked for a tally of votes from the Secretary.

The Acting Chairman noted that he understood that 70 percent of total voting power was required for such a decision.

The General Counsel confirmed that a 70 percent majority was required because of the effect of such a decision on the rate of charge and, if creditors were included in the refund, the rate of remuneration.

The Secretary said that it was clear that a 70 percent majority did not exist.

The General Counsel, in response to a question by Mr. Sengupta, explained that abstentions were equivalent to objections when it was a matter of adopting a decision by a percentage of total voting power, rather than of total votes cast.

2. TRINIDAD AND TOBAGO - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Trinidad and Tobago (SM/87/238, 9/25/87; and Cor. 1, 10/23/87). They also had before them a background paper on recent economic developments in Trindad and Tobago (SM/87/240, 10/14/87; and Cor. 1, 10/23/87).

Mr. Hospedales made the following statement:

> We would like to express our appreciation for the concise and well-balanced set of technical papers prepared by the staff following the Article IV consultation discussions in Port-of-Spain in July. My authorities feel that the papers are constructive and would be helpful in the formulation of the macroeconomic and structural adjustment program which is now under way. This program would restore sustained and balanced economic growth within a climate of financial stability. Some of the critical elements of the Government's program will be reflected in the 1988 budget, which will be presented to Parliament before the end of this year.
>
> Economic and financial conditions remain difficult in Trinidad and Tobago in the wake of the highly unfavorable international economic environment of recent years, particularly the dramatic decline in the price of oil in 1986 and the unwelcome experience of net transfers to external capital markets by the public sector. Real GDP continues to contract, and unemployment has begun to assume critical proportions. The larger than expected loss in export earnings from the petroleum sector in 1986--approximately US$750 million, or nearly 56 percent of the 1985 level and 14 percent of GDP--has resulted in the emergence of substantial internal and external imbalances:
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> -- Government revenue decreased by 5.4 percent of GDP, the fiscal deficit widened to 6 percent of GDP, and the overall consolidated public sector deficit reached 9.1 percent of GDP. It should be noted, however, that the widening of the deficit conceals a very large adjustment in public expenditures, particularly development expenditures, which were curtailed by the equivalent of 5.1 percent of GDP.

The gap between savings and investment is widening, and the deficit on the current account of the balance of payments reached the equivalent of 10.4 percent of GDP, compared with 1.2 percent in 1985; public sector net capital inflows fell sharply to approximately US$20 million; net international reserves fell by approximately US$664 million to US$331 million at the end of 1986, which is equivalent to about three months of import cover; and net external debt amounted to US$1.8 billion or 33 percent of GDP.

The new Government which took office on December 16, 1986, recognized fully the acute economic crisis and immediately took action to contain the situation. The Government also recognized the need to implement a set of consistent and coherent policies within a medium-term framework which would lay the foundation for the resumption of growth and employment, and established appropriate institutional mechanisms to accomplish these goals.

The first and central element in the Government's program centered on measures to address the underlying imbalance of the public sector which is directly linked to the net external drain. The 1987 budget must be viewed as a significant first step toward a medium-term fiscal strategy to restore internal and external balance.

The Government's budget introduced a number of tax measures, notably additional indirect taxation and the creation of a "national recovery impost." A major tax reform is being formulated to improve the elasticity and efficiency of the tax system, to broaden the tax base principally through indirect taxation, and to strengthen tax administration procedures. With particular reference to the petroleum sector, existing legislation is being urgently reviewed with the objective of promoting exploration and production activity.

Expenditure control mechanisms are ensuring greater discipline. The budget suspended the payment of cost of living allowances and merit increases to public service employees. These expenditures were equivalent to 2.8 percent of GDP. Additionally, transfers and subsidies to nonfinancial public enterprises have been largely limited to the servicing of debt obligations. This step will reduce the financial burden on the central government, and encourage better management and financial discipline. The program of enterprise reform which is being actively pursued, aims at enhancing efficiency and promoting capital restructuring and, where appropriate, divestment.

Despite the measures related to recurrent revenue and expenditure, the adjustment has continued to fall largely on capital expenditure, which has declined to unacceptably low levels, barely 2.3 percent of GDP this year. My authorities are deeply conscious of the need to establish a capital program of appropriate quality and size, and they are in the process of identifying and formulating a core investment program. Priority is being given to improving the utilization of existing capital stock in the petroleum sector by advancing the rationalization program which builds on the previous purchase of assets from two major producers; a careful and judicious selection of new investments in the areas of tourism, agriculture, and manufacturing; and a large-scale settlement program which is well under way.

My authorities are of the view that sustained growth must be based on greater participation by the private sector in the economic development of the country. Therefore, the Government is determined to create an environment which is supportive of private investment, and ensures that adequate resources are available to the private sector.

Private foreign investment is also expected to play a key role in the process of economic recovery. Accordingly, a liberalized foreign investment code, including the establishment of a 'one-stop shop' to ensure rapid processing of investment applications, has been established. While the Government recognizes that increases in investment must be financed primarily from domestic resources, it hopes that foreign investment and financing will be forthcoming in response to these policies for restructuring and transforming the economy--particularly the state enterprise sector where massive capital investments in export-oriented industry have taken place--an objective which is realizable only with considerable time lags. My authorities hold that the country's record of macroeconomic adjustment and timely debt repayment, despite substantial sacrifice, merit external financial support.

Credit expansion and advances to commercial banks have been carefully monitored in view of the continuous drain of net international reserves. Indeed, in the period January to September 1987, the absolute loss in net international reserves has been significantly less than for the same period in 1986. My authorities expect that the correction of the fiscal imbalance will eventually result in lower interest rates. Such a development will facilitate the resumption of sustained noninflationary growth.

Apart from the influence of external developments on the medium-term scenario, my authorities view rising non-oil exports over the next few years as a crucial element in resuming the diversification process and growth within the context of a sound external position and price stability. The importance of exchange rate policy in this regard has been evidenced by the unification of the exchange rate in January 1987, which combined with the devaluation of December 1985, has served to restore essentially the international competitiveness of the TT dollar to the 1980 level. Additional action in this area would be subject to a careful evaluation of the various implications they could have, including the sequencing of trade liberalization measures under consideration; in this connection the foreign exchange budgeting program is being managed with greater flexibility. However, the competitive strength of the economy will be buttressed by close adherence and commitment to the strong wage restraint policy which has been reinforced by my authorities since their assumption of office. The recent decline in real wage costs is indicative of this policy stance. We wish to clarify also that the Central Bank does approve tourist travel allowances in excess of the maximum amount delegated to the commercial banks.

The severe loss of export earnings suffered by Trinidad and Tobago cannot be fully compensated by domestic economic adjustment in the short run. My authorities believe that their commitment to re-establishing balance in the economy requires a measure of external financing to complement the strong domestic efforts being undertaken. Failing external financial support, and given the unfavorable maturity structure of external debt over the near term, re-establishing balance in the economy through adjustment alone would impose an excessive burden on the economy and act as a drag on the process of national economic reconstruction and development. In this connection, and given the difficulties of access to private capital markets, my authorities reiterate the importance of readmission to borrower status with the World Bank as a primary source of long-term development capital.

Mr. Foot made the following statement:

The authorities have made significant efforts to strengthen the economy over the past few years in response to the weakening external position. However, these initial efforts were largely offset by the renewed weakening of the oil market last year. The Government that took office at the end of 1986 responded quickly to the worsening external position. Public expenditures were cut sharply, and as a result, the final deficit was not much larger than the initial target. The process of structural reform has continued.

In general, the authorities seem to have reacted with commendable speed to contain the deterioration of the economy. However, these responses had an ad hoc air, and I would recommend establishing a comprehensive medium-term framework for policy.

The staff's medium-term balance of payments forecast suggests that the external position is likely to remain tight, and much depends upon trends in the oil market. However, it is clear that the authorities need to pay close attention to the general issue of competitiveness. The devaluation in late 1985 has apparently had a positive impact on the country's competitiveness, and it may help to explain the fairly good performance of nontraditional exports last year. Even so, the real effective exchange rate remains 10 percent higher than it was in 1980. In addition, the authorities continue to rely on relatively tight import controls. Meanwhile, energy related exports constitute 87 percent of the total, and the trade regime seems to have led to some activities in which Trinidad and Tobago does not appear to have a comparative advantage. For example, assembled cars are on the negative import list presumably to encourage the local assembling industry. In general, there seems to be a need to reduce the level of protection in order to promote more efficient import substitution and the expansion of nontraditional exports. Meeting this need will require supportive wage and exchange rate policies. The authorities seem to have made significant progress in reducing wage pressures last year. The decision to suspend cost of living adjustment payments in the civil service has probably played a helpful role in this connection.

However, wage restraint alone may not be sufficient to yield the required impetus to nontraditional exports. The authorities are apparently reluctant to take further action on the exchange rate front, because they fear that it would quickly affect wages. While I understand this concern, it should be eased if aggregate demand policies are sufficiently supportive.

In diversifying the economy, it will be important to ensure that the private sector is encouraged. I was glad to see that the authorities are taking steps to encourage direct investment, and that they have reunified the exchange rate and allowed the prices of imported goods to fully reflect the change in the exchange rate. However, a fairly complex system of price controls still remains in place, and I hope that the authorities will consider further liberalization.

The authorities have already begun the process of reforming public enterprises. This is important, because these enterprises have become an important drain on the budget due to both the subsidies they receive and the substantial losses some have shown. For example, I note from the background paper on recent economic developments in Trinidad and Tobago that despite cost-cutting measures, CARONI's cost structure for sugar production is still several times higher than even the European Communities' premium price, which is much higher than prices prevailing on the world market. I was interested to see that a diversification program has been established, which aims to sell some of the land owned by the public enterprises to the private sector and expand the production of cash crops.

I share the staff's concern about the large cost of financial intermediation in the economy. I note from the background paper that these costs may reflect relatively high labor costs in the financial sector. I agree with the staff that there is an apparent need to promote greater competition in the financial sector. A more active bank rate policy may be needed.

The authorities have made significant efforts to tackle their economic problems, and they seem to be going in the right direction. Still, it is clear that the medium-term balance of payments position will remain difficult. It is important that recent progress be maintained. This will require not only firm demand-management policies, but also continued structural reform.

Mr. McCormack made the following statement:

Because of its heavy dependence on petroleum products, the economy of Trinidad and Tobago has exeperienced severe difficulty over the last five years, with the impact of the sharp fall in oil prices last year being particularly acute. The scale of these difficulties is perhaps best summarized in a single statistic: between 1982 and 1986, real GDP, adjusted for the terms of trade, fell by a full 55 percent. Lower oil prices have put heavy strains on the balance of payments and on the public finances. In addition, the worsening economic situation exposed serious structural problems, particularly in the financial sector. However, there appears to be a considerable measure of agreement between the authorities and the staff concerning immediate policy priorities.

The Government that took office in December 1986 is to be commended for the vigor with which it has addressed the economy's difficulties. Particularly commendable measures included: the unification of the exchange rate, the early introduction of a new tax package, and suspension of the cost of living allowances that had been granted in previous years. In its report, the staff commented that there is no comprehensive medium-term strategy for stabilizing the economy and for laying the basis for sustained growth. Such a strategy is clearly needed at the present juncture. Therefore, I welcome the assurance that the formulation of such a medium-term macroeconomic and structural adjustment is now under way. An early conclusion of this work would help to sustain the momentum created by the Government's initial policy measures, and create a framework for private decision making in the medium term.

I commend the authorities for the degree of restraint they have been able to exercise over the growth of government expenditure. The suspension of the cost of living allowance and the containment of government transfers and subsidies to state enterprises are positive steps. Expenditure restraint will need to be maintained over the coming years, and the need for durable improvements in the fiscal situation will call for reforms of a structural nature. The authorities' intention to introduce a major tax reform to improve the elasticity and efficiency of the tax system and broaden the tax base is welcome, as are measures to strengthen tax administration. I would like to know how long it will take for concrete measures to be put in place. I note on page 9 of the staff report that at the time of the consultation, the authorities believed that measures to establish a broadly based sales or value-added tax would require considerable time.

In view of the weakness of the public enterprise sector, its overmanning and apparently poor management, the conclusions and recommendations of the panel responsible for reviewing the public sector are awaited eagerly. Public enterprise reform envisages, where appropriate, divestment, and I would be very interested to know whether any concrete proposals regarding this have been brought forward.

The fiscal adjustment of recent years has fallen relatively heavily on capital expenditure. The authorities' intention to identify and formulate a core investment program is an important step toward ensuring continuity in the development effort. I would also emphasize the importance of the qualitative as well as the quantitative aspects of any prospective investment program.

In recent years, the financial system of Trinidad and Tobago has experienced significant strains, which necessitated official intervention with respect to some nonbank financial intermediaries in late 1986; these institutions had apparently been involved in speculative real estate transactions. Consequential institutional changes included the creation of a deposit insurance corporation. The necessity to stabilize the financial system is evident: the impact on confidence, both domestic and external, of the collapse of any significant financial institution is literally incalculable. The legislation concerning the deposit insurance corporation and the supervisory function of the Central Bank was reviewed by a Central Banking Department technical assistance mission in September 1986. It appears that legislative amendment is needed to strengthen the banking supervision function. Such legislation is invariably complicated and technical and therefore, time is needed to bring such reforms through the various legislative stages. A speedy initiation of the process is desirable.

Because of the difficult medium-term balance of payments outlook for Trinidad and Tobago, exchange rate policy is particularly important. The recent unification of the exchange rate was a welcome step. However, I have some reservations about the thinking of the authorities on the appropriate level of the exchange rate. It is true that the exchange rate in real terms has now been restored to virtually the same level that prevailed in 1980.

However, since then, the terms of trade have deteriorated substantially. Unemployment is very high, almost double that of the early years of the decade, and the performance of nontraditional exports has been weak. Also, even if they are implemented flexibly, foreign exchange budgeting systems involve distortions. On balance, therefore, I tend to support the staff view that a flexible approach to exchange rate management is needed to ensure a level of competitiveness consistent with a satisfactory balance of payments position and sustained economic growth.

Despite the very considerable difficulties it has encountered, Trinidad and Tobago has a record of timely debt repayment. I would commend this, were it not for the fact that such a record ought to be the norm. Trinidad and Tobago appears to be encountering difficulty in gaining access to private capital markets, and the authorities have stressed the importance of regaining access to World Bank resources. This issue is outside the jurisdiction of today's meeting. However, our counterparts in the World Bank are aware of the authorities' concern in this regard, and they have a degree of sympathy with the authorities on this point. They believe in a flexible approach to World Bank graduation, which takes the development needs of the concerned countries into account.

Mr. de Groote said that the staff appraisal left no doubt that the authorities had only a limited number of options. Adjustment with growth and the development of a comprehensive medium-term strategy were clearly needed to end the long recession that Trinidad and Tobago had borne since 1980; to that end, a reduction in the high unemployment rate and a stabilization of the level of per capita income were necessary. The fact that 80 percent of export earnings were related to the oil sector clearly indicated that a diversification in the export base was also required. That the authorities fully recognized those needs was welcome.

It was not only the drop in oil prices that had caused the recent decline in economic activity, Mr. de Groote remarked; the depletion of the oil wells had also contributed to the fall in revenues, and Trinidad and Tobago had failed to reorient its development strategy in the right direction in time. However, the chances for achieving a sustainable positive rate of growth had been greatly enhanced by the relatively low rate of inflation. The functioning of the financial system had to be improved within a revised legal framework that would meet the various needs of the economy. Enhanced banking supervision was refined to ensure a sound banking system and diminish financing market imperfections, such as the elimination of portfolio guidelines.

In light of the recent deterioration in the terms of trade and the increase in the rate of inflation compared with other countries, a flexible exchange rate policy was desirable, Mr. de Groote noted. Mr. Hospedales had observed that the 1985 devaluation had restored the international competitiveness of the TT dollar to approximately the same level as 1980. However, it was questionable whether the 1980 position was really a good point of comparison, owing to the exceptionally high level of expenditure that had existed at that time, reflecting the favorable oil market situation. He wondered whether a somewhat more competitive exchange rate should be considered.

A reform of the tax and custom systems was obviously overdue, Mr. de Groote commented. A value-added tax and a reduction of tariff protection and quantitative import restrictions were needed to remove distortions in the economy. Small economies could not afford to maintain protection, nor could they afford to be the victims of protection.

The planned liberalization of the regulation of foreign participation in domestic projects was especially welcome, Mr. de Groote added. However, the Government's intention to allow majority ownership in only certain cases was questionable. Foreign ownership would permit the transformation of external debt into equity, thereby making the debt burden more independent of international interest rates. In addition, if capital inflows were sufficient, they could help to prevent the external debt from continually rising until 1992, as forecast in the staff report.

Trinidad and Tobago should be readmitted to borrower status in the World Bank, a primary source of long-term development capital, Mr. de Groote commented. Convincing corrective measures had been undertaken, and external financing was needed to help rapidly restore a desirable rate of growth. The potential market investors did not correctly perceive Trinidad and Tobago to be a country that had favorable medium- and long-term prospectives. However, if assistance were given to alleviate the unfavorable maturity structure of the debt in coming years, positive growth could be achieved. In fact, there were few other cases in which such a high multiplier effect could be obtained from new external market financing. Therefore, he hoped that the World Bank would be persuaded to play a useful role in helping Trinidad and Tobago--a country that would have exceptionally favorable medium- and long-term growth prospectives if it could overcome its temporary financing difficulties.

Mrs. Filardo made the following statement:

> One major cause of the current economic problems facing Trinidad and Tobago is the sharp decline in international oil prices, which began in 1981 but accelerated drastically at the beginning of 1986. Before 1982, reliance on the oil sector for both government revenue and foreign exchange earnings grew substantially, rendering the economy vulnerable to external shocks. Conduct of economic policy posed very difficult problems, and progress in narrowing the fiscal and current account deficits up to 1985 was obtained at the cost of continuously falling real GDP and mounting unemployment. Under these circumstances, the scope

for further adjustment, after the aggravation of the terms of trade in 1986, was very limited, and yet the authorities did not hesitate to stiffen their policies.

The staff report and Mr. Hospedales's opening statement indicate that the measures adopted were effective in containing the adverse consequences of the external shock, particularly the reduction in foreign finance. These measures, however, cannot be seen as constituting a program that is oriented towards enhancing growth and stability. Some measures, like the freezing of public wages, cannot be sustained; others, such as controlling import prices, generate costly distortions. It is important, therefore, that the Government move in the direction of a sustainable longer-term program. I wish to stress this point because, although the country appears to benefit at present from positive relations with commercial creditors, the lack of clear signs of economic improvement and firm commitment by the authorities could weaken the support of financial institutions, and, consequently, jeopardize prospects for recovery.

Because I broadly agree with the staff's appraisal, I will limit myself to emphasizing a few points. Regarding the exchange rate policy, I concur with the authorities' view that in the short run productive capacity may limit the impact of further depreciation on exports; however, the exchange rate serves the dual purpose of containing domestic absorption and orienting new investment to more profitable sectors. The unification of the exchange rate is a step forward, but a more flexible management would be appropriate, if the policy is aimed at simulating a more diversified export sector. Although the real effective exchange rate is close to its 1980 level, the deterioration in the terms of trade since then, and the increased public indebtedness, suggest a need for further depreciation. In this connection, a reduction in the dispersion and level of trade protection should increase the effectiveness of the exchange rate policy and should therefore be pursued more actively. The same arguments support the view that the price freeze on imported goods subject to price markups should be promptly lifted.

The staff should comment further on the medium-term balance of payments forecast. Imports as a proportion of GDP are assumed to remain constant through 1992 at the current depressed level while supporting a recovery in real GDP. Does this forecast assume a change in their composition, or a rapid process of import substitution?

Although a small economy is more liable to specialize in only a few sectors and, therefore, to be more vulnerable to external shocks, the authorities should incorporate the measures mentioned during the discussion into their medium-term program to promote flexible responses of the economy to internal and external shocks. This effort, in turn, should attract the support of the international financial community. In this regard, I tend to agree with Mr. de Groote that the World Bank could play an important role in Trinidad and Tobago's development, especially in aiding the country to overcome its present structural problems.

Mr. Parmena made the following statement:

The authorities have been trying to address the problems which emerged as a result of the adverse developments in the world oil markets. However, the progress which was made in 1984-85 to contain the imbalances was reversed by a further sharp drop in oil prices in 1986, and internal and external imbalances were further aggravated causing real GDP to decline by more than 6 percent and the inflation rate to rise to 10 percent. Furthermore, the unemployment rate reached 18 percent, and the fiscal and current account deficits widened to 6 percent and 10 percent of GDP, respectively. I note from the staff report and from Mr. Hospedales's statement that the new Government, recognizing the gravity of the situation and realizing the need for quick action, introduced a number of corrective measures in exchange rate and fiscal policy and embarked on the preparation of a more comprehensive medium-term strategy to put the economy on a path of sustained growth with financial stability.

My authorities are in general agreement with the staff analysis of recent economic developments and Mr. Hospedales's candid description of the authorities' policies. I fully understand that the need for fiscal consolidation and expenditure containment is a key element in the stabilization process. However, such expenditure restraint should be consistent with the long-term growth objective. Therefore, emphasis should not be on the mere reduction of public expenditure, but on the need to strengthen public sector savings. My authorities raise this point because development expenditure has so far borne the brunt of adjustment and, as Mr. Hospedales said, "has declined to unacceptably low levels." This is an important point in the light of not only long-term growth, but also the need to diversify the economy's production base and to reduce its dependence on oil and its vulnerability to adverse developments in the oil sector. It is encouraging to note that the authorities are conscious of the importance of public sector savings and of the need to establish a capital program of appropriate quality and size. Perhaps a strengthening of government revenue through tax reform and improvement of its administration along the lines stated in the staff report could provide a means to strengthen public sector savings.

I endorse the authorities' view on the role of foreign investment in the process of economic recovery, diversification, and long-term growth. The measures taken to liberalize and simplify the foreign investment code, including the establishment of a "one-stop shop" for processing investment applications, should facilitate and encourage foreign investment in Trinidad and Tobago. However, the need for continued sound economic policies in creating an environment conducive to investment cannot be overemphasized.

While it is important to stress that adjustment is the responsibility of national authorities and that domestic policies are the key factors in achieving such adjustment, without adequate external financial support domestic policies can hardly succeed. In this regard, I support the authorities' request for readmission to borrower status with the World Bank, and urge Fund management to play a catalytic role toward that desired objective.

Mr. Fernando made the following statement:

The medium-term external outlook for Trinidad and Tobago contains many elements for concern. Perhaps the most serious is that even though the authorities are aware of the scope and depth of the economic problems, and have taken many policy initiatives to address the imbalances, there is a great deal of room for improving the comprehensiveness of the corrective effort. It is reported in the staff papers before us that the authorities are engaged in an internal dialogue to seek a consensus, but time is not on Trinidad and Tobago's side.

There is more room than the statistics suggest for growth in GDP and international trade. The lack of growth, of course, arises from the perceived overvaluation of the exchange rate. The level of international reserves is also lower than is suggested by the estimates, because imports have been compressed through direct trade and exchange controls. The medium-term outlook is highly sensitive to price and output developments in the oil sector. While price expectations do not appear to be overly optimistic, I wonder whether expectations regarding output increases can be realized, especially as current prices have made some production facilities uneconomic.

A question that has not been answered is what options or contingency plans can the authorities activate if developments in oil prices or output are disappointing? In this context, I wonder whether natural gas has the potential to make a direct and quick impact on the balance of payments. I am concerned that natural gas-based products like urea, ammonia, fertilizer, and steel will face uncertain external markets. The subsidies extended to these industries may also run the risk of countervailing GATT provisions.

Another issue that has not been clearly focused on is the authorities' perceptions of economic growth. Three successive years of falling output, and a 40 percent loss in the terms of trade last year could have already eroded productivity and business confidence. The documents before us clearly indicate the financing constraint faced by Trinidad and Tobago. Domestic savings have been inadequate to finance even a moderate level of productive investment. The terms of trade losses and factor payments abroad have eroded the base of savings. In addition, accumulated savings in the form of external assets have been run down.

The authorities are to be commended for the actions they have taken so far to generate savings for investment, such as current expenditure restraint and public enterprise reform in the fiscal area, and incentives for foreign direct investment in the private sector. However, these measures should be complemented by other actions to mobilize household and business savings through improvements in the financial sector and monetary policies that induce positive returns to savers.

The exchange rate will play a central role not only in Trinidad and Tobago's short-term stabilization effort, but also in the medium to long term, if restoration of economic growth is to be achieved. The economy is highly open, and there is a pressing need for sustained progress in the diversification of the productive base for both efficient import substitution and exports. International reserves will have to be speedily built up from the current low level to provide for growth-promoting imports.

In the area of the exchange rate, the authorities have taken courageous steps, including the real effective depreciation and unification of the exchange rate. However, further action seems to be indicated, because of recent developments: there has been a substantial decline in the terms of trade; international reserves are very low and have to be built up; and debt service costs are higher. The authorities have correctly taken action to restore competitiveness by restraining wage costs.

The exchange rate has been pegged to the currency of Trinidad and Tobago's principal trading partner. I wonder what the authorities' view is on the need for a more aggressive, outward-oriented policy, under which developments in potential competitor countries should be considered.

The staff report emphasizes the importance of supporting Trinidad and Tobago's adjustment effort with adequate financing. Strong and sustained policies are required, and many actions in this direction have been taken. A comprehensive reform package would consolidate the basis for market access, as the country's record of amortization and debt service has been excellent and should not be overlooked. In Trinidad and Tobago's case, balance of payments support seems to be more important, for the moment, than project support, and this underlines the case for a set of comprehensive policies. In this context, I wonder whether the authorities contemplate the use of Fund resources. We also think that Trinidad and Tobago's situation and the economic adjustments undertaken are grounds for reopening the question of access to World Bank resources.

Mr. Lim noted that the Article IV consultation was the first such consultation with the new administration. The staff report aptly described the difficult economic environment that the new administration faced and the imperative need to arrest the continuing decline in national income, employment, and the external position.

It was therefore encouraging to note the corrective measures that had been immediately undertaken by the new administration, which sought to eliminate the distortions caused by the dual exchange system and to minimize public sector imbalances through greater restraint on current public expenditures, Mr. Lim continued. The initial results of budgetary balance and the improved external performance in the first half of 1987 were also encouraging.

For the medium term, Mr. Lim said he agreed with the staff and the authorities that the comprehensive macroeconomic and structural adjustment program to be formulated should focus on fiscal reforms that would allow greater accommodation for private investment; financial reforms that would give the banking system a greater market orientation and reduce the cost of financial intermediation through minimal financial regulations; and trade policy reforms that would further liberalize the country's trade and payments system. If the initial action of the authorities indicated their determination to address the current imbalances he had no doubt that, with adequate external financial support and stable oil prices, the authorities would succeed in reversing the declining trend in real GDP, and in achieving a viable balance of payments position in the medium term.

External financial assistance was a key element in at least the initial stages of the medium-term strategy, given Trinidad and Tobago's heavy reliance on oil exports and the time required to diversify exports, Mr. Lim commented. He agreed with Mr. Hospedales that the serious loss of export earnings could not be fully recovered in the short term by domestic economic adjustment alone. Given both the thinning of the commercial financial markets and the unfavorble maturity structure of external debt in the near future, he understood the authorities' desire to regain their financial access to multilateral development institutions such as the World Bank to secure long-term development capital.

Mr. Hogeweg made the following statement:

Trinidad and Tobago seems to have started its adjustment to the decline in oil prices quite well. A large devaluation and very restrictive fiscal and wage policies were carried out. However, the staff is correct in pointing out that more will have to be done, and that a comprehensive medium-term strategy is needed; and the authorities entirely agree.

The staff recommends that the Central Bank should raise its bank rate to a level which would discourage other than temporary borrowing by the banks. Evidently, the Central Bank's lender of last resort function in a financial system with weak intermediaries has complicated a restricted monetary policy stance. I suspect that, in this regard, prudential supervision issues and monetary policy issues have been confused. Of course, the stronger the financial system is, the less need there will be for more or less permanent lending of last resort. In addition, lending by the Central Bank for prudential purposes can complicate money market management if no compensating measures are taken, for instance, in the field of reserve requirements. However, one should separate, both analytically and in the implementation of central banking policy, prudential and macromonetary issues. The degree of permanence of lending by the Central Bank to the domestic banking system as a whole depends on the structure of the Central Bank's balance sheet. Of particular importance are items such as official reserves on the one hand, and bank note circulation and reserve requirements on the other. Of course, the domestic interest rate level can influence the balance sheet structure. The more attractive assets in domestic currencies are, the more foreign exchange will be sold to the banks, and the better the opportunity the Central Bank will have to increase its reserves, or to prevent a decrease. However, the point is that permanent lending by the Central Bank to the banks is perfectly compatible with a tight monetary policy; it allows the Central Bank to dictate its own credit conditions to the banks and, via the banks, to the domestic economy. Last resort lending complicates monetary management when it changes the mix of central bank credit on items on which the interest rate charged cannot be used for macroeconomic purposes. As was stated earlier, the proper mix can be restored by compensating measures.

There is a clear need for higher interest rates, which in real terms are negative over a wide spectrum. In the longer term, an interst rate hike is preferable to a continuation of lending guidelines and would facilitate the dismantling of external controls. The existence of trade and exchange restrictions may appear to indicate that the exchange rate is still overvalued. However, the low interest rate level complicates judging the appropriate level for the exchange rate. Therefore, I am not sure what to think of the staff's policy advice on a further devaluation. The authorities' emphasis on domestic cost measures is entirely justified for a small, open economy like Trinidad and Tobago's. Of course, the seemingly easier way to improve competitiveness through a devaluation does not obviate the need for domestic measures. These considerations make a judgment on the issue of a devaluation especially complicated.

Ms. Walker made the following statement:

It is unfortunate that Trinidad and Tobago faced considerable economic difficulties in 1986 after the improvements of 1984-85. While the Government has taken some important steps which have helped stem the weakening fiscal situation, it is clear that further action must be taken to bring about economic recovery and restore balance of payments viability. The debt service burden during the rest of the decade, and the financing requirements outlined in the medium-term scenario, put even greater pressure on the authorities to devise a comprehensive medium-term economic program that will achieve these goals. In this regard, I welcome the authorities' recognition of the need to implement a set of consistent and coherent policies that will address their economic problems and help restore growth and balance of payments viability, and they should complete such a program as soon as possible. A comprehensive strategy of economic adjustment should also help restore private capital market flows to Trinidad and Tobago.

The authorities' intention to reduce the fiscal deficit, particularly through the scope of public sector operations, is a positive step. A reform of the public enterprise sector should greatly assist in this effort, particularly if serious consideration is given to divestment. Meanwhile, it is critical that those entities become more efficient so that they can reduce the drain on the public sector budget, and that supervision of public enterprises be strengthened as envisioned. The review and reform of the tax system should also contribute to alleviating the fiscal problems. Particular attention should be given to tax incentives in the areas of foreign and domestic investment.

I agree with the authorities that sustained growth must be based on greater participation of the private sector in the economy. Private foreign investment should play a role in this regard, and, therefore, I welcome the planned relaxation of foreign investment rules. Reform of the public sector should also help in this regard.

The difficult monetary position of the Central Bank must be kept under constant review. It is important to keep the Central Bank's role as lender of last resort on a temporary basis. In this regard, it seems advisable that the bank rate be raised to a level similar to the lending rates in the banking system. The solvency of the banking system must be maintained, and, therefore, close supervision by the Central Bank of the banking system will be critical.

I welcome the authorities' recognition of the fact that a decline in real wages will be necessary for the adjustment process to be carried out. In fact, it is this decline that has contributed to the maintenance of Trinidad and Tobago's competitiveness. However, wages alone will not maintain the competitiveness of the economy in the face of exchange controls and restrictions. More efficient resource allocation would be achieved if the authorities removed such controls and restrictions and continued to manage the exchange rate flexibly. The unification of the exchange markets is a positive step in this direction.

The conclusion of a comprehensive policy package will be critical to the restoration of growth and balance of payments stability in the medium term. The authorities should develop a full-fledged, overall plan for the economy. Their commitment to this, as evidenced by the steps taken thus far, is positive.

I have no comment on the World Bank issue that was raised by Mr. Hospedales; this is not the appropriate forum in which to discuss that issue.

Mr. Rouai noted that Mr. Hospedales had emphasized that the sharp oil price decline of 1986 had a negative impact on the economy of Trinidad and Tobago and had offset the improvements that had been achieved in 1984-85. While real GDP had continued its declining trend, the overall public sector deficit had risen and the current deficit had widened. Other negative developments included the worsening unemployment situation and the accelerated rate of inflation. The authorities' reaction to those difficulties was immediate and centered on the public sector, with the introduction of a number of measures to raise tax revenues and reduce government expenditures through cuts in wages and subsidies.

Along with those corrective measures, Mr. Rouai said, the new Government was preparing an adjustment program to address the structural rigidities of the economy and to correct internal and external financial imbalances. A special emphasis would be placed on the private sector--local as well as foreign--to increase its participation in the economy. Concomitantly, the role of the public sector would be reduced through a restructuring of the state enterprises. In that context, the authorities would pay special attention to the labor market to alleviate the unemployment situation.

While the authorities were committed to adjusting the economy, external financial support would be essential in the coming years given the profile of the external debt, 92 percent of which was scheduled to mature within five years, Mr. Rouai commented. In that connection, there was a clear need to restructure Trinidad and Tobago's debt obligations.

Mr. Morales said that Trinidad and Tobago had faced a very difficult economic situation during the past year. The fiscal deficit widened, the deficit in the current account of the balance of payments reached 10.4 percent and international reserves decreased sharply. At the same time, production activity continued to decline and unemployment peaked. The recent economic situation was a clear consequence of an unfavorable international environment, in which the decline in oil prices had more than offset the efforts of adjustment pursued by the Government. As Mr. Hospedales mentioned in his opening statement, the loss in export earnings was $750 million, equivalent to 14 percent of GNP, and the adjustment effort in the fiscal area curtailed public expenditures by the equivalent of 5.1 percent of GNP in 1986.

The measures undertaken by the authorities since January 1987 and the positive results achieved so far were welcome, Mr. Morales remarked. The recent unification of the exchange rate was commendable, and the management of the exchange rate should be viewed in the future with a flexibility that would be consistent with the required level of competitiveness.

In addition, the authorities' commitment to addressing the imbalances of the economy with a set of coherent policies that, within a medium-term strategy, could re-establish growth and employment was welcome, and the authorities should implement their policies in a medium-term context, Mr. Morales continued. He agreed with the staff that the authorities should consider the reduction of both the fiscal deficit and public expenditure as a key element of the adjustment program. In that connection, the measures taken in the revenue side of the 1987 budget and the authorities' commitment to ensuring greater discipline on expenditures were noteworthy, as was the fact that two special panels had been established to evaluate a needed structural reform of the tax system and the operations of the state enterprises. Those were certainly steps in the right direction and the results, when reached, should be implemented as soon as possible.

The authorities were in the process of implementing an adjustment program in the context of a difficult external environment and they should be encouraged to persevere with their policies, Mr. Morales went on. Nevertheless, the fact that Trinidad and Tobago was not considered a borrower in the World Bank was puzzling, although the administrative reasons for that decision were understandable. It was clear that Trinidad and Tobago would require large external financing over the medium term, and an adequate mix of adjustment and financing would be necessary to eliminate the imbalances and avoid excessive harsh effects on domestic economic activity and living standards. Trinidad and Tobago would require long-term funds from multilateral lending agencies to finance the needed structural reforms.

The staff representative from the Western Hemisphere Department said that the authorities had not made any specific comment on the timing of fiscal reform actions, but it was the staff's impression that the authorities were thinking of acting in certain stages. For example, on the question of tax reform, the Government was intent on taking measures in the very near future to improve the tax yield--for example, steps to improve the coverage of the income tax. They had recently extended the income tax withholding system to interest and dividend payments. They were also considering actions to improve the collection of purchase taxes through better enforcement, including the application of fines.

The second stage of action that the Government was considering was rationalizing the petroleum tax regime, perhaps to provide better incentives for production, the staff representative continued. There were also structural measures, which seemed to be for a later stage, reforming the domestic tax structure to cover a broader base of transactions.

There also seemed to be a plan to work in stages to reform the public enterprise sector, the staff representative observed. The committee that had been set up at the beginning of the year to look into the operations of the public enterprises was considering ways to deal with certain small institutions which had been set up to provide services for the Government; the possiblity of eliminating them was being considered. At a later stage, the Government would deal with some of the larger corporations in the economic sphere.

A question about the discussion in the staff report on the development of the real effective exchange rate had been raised by Mr. de Groote, the staff representative recalled. The staff had not made a judgment as to whether 1980 would be an appropriate base year for judging the adequacy of the current level of the exchange rate, but there were a few features of the economic situation in that year that gave some validity to such comparisons. First, 1980 predated the terms of trade decline that Trinidad and Tobago had experienced almost continuously since 1981-82. Second, in 1980 and the early years of the decade there was a minimum of exchange controls, or direct intervention in the exchange market and trading system. Third, the external debt situation was very different in 1980 from the present one.

A question had been raised about the comparison between the prudential and macroeconomic objectives of monetary policy, the staff representative remarked. When one looked at the present balance of payments difficulties of Trinidad and Tobago from a monetary perspective, one could discern pressures coming both from the private and public sectors. The pressures from the public sector were clearly the most important and intense, and they were reflected in the large imbalances that had been evidenced in the public sector. They explained, to a large extent, the rundown of reserves over the last few years. But all the reserve losses, especially those in 1986 and 1987, could not be explained simply by looking at the position of the public sector; the private sector also was imbalanced, as was reflected in the credit demands on the Central Bank from the banking system, which in turn reflected the problems of credit development, loan recovery, deposit growth, loss of reserves, and erosion of capital in the financial system.

The concern the staff had expressed in its discussions with the authorities was that, owing to the private sector imbalance, there had been pressures on the Central Bank, some of which had had a permanent effect on the system, the staff representative continued. One source of pressure was the fact that loans which had been granted to finance houses in the last few years to assist them in periods of trouble, had been written off against profits of the Central Bank and, therefore, had become a permanent reserve loss. Later in 1987, the Central Bank would probably have to begin making some advances to the Deposit Insurance Corporation to help it meet the claims of depositors. That loss would appear to be a permanent one.

Another issue that had been raised during the discussions was the credit policy of the Central Bank vis-à-vis the banks and reserve deficiencies, the staff representative from the Western Hemisphere Department said. The staff agreed with the authorities that the situation was manageable as long as the Central Bank took steps to carefully supervise the use of the credit, and to engage in a program with each of the institutions to ensure that loans were recovered by the Central Bank. Part of that process might, or should, involve an increase in the bank rate. For example, the bank rate was now less than that of the interbank rate in the system. Therefore, there was a greater incentive for the banks to borrow from the Central Bank than to gain resources elsewhere in the system.

Mr. Hospedales reiterated his authorities' deep commitment to the imperatives of adjustment that had been imposed by new circumstances: the dramatic declines in the price of oil, in public revenue, in the current account of the balance of payments, and in future resource availability. It was very important that demand should align itself with the availability of resources. To that end, when they assumed office in December 1986 his authorities had immediately acted to strengthen public finances and to restructure the public enterprises. They had been aware of the need for structural reforms to ensure that the economy operated at maximum efficiency, and had continued the process of structuring a relative set of costs and prices to ensure the unification of the exchange rate. The unification had followed a deep devaluation in December 1985. It was now widely accepted by manufacturers that the exchange rate was broadly appropriate, competitive, and credible.

The authorities had also initiated a process of external adjustment and internal restructuring, Mr. Hospedales added. The budget for 1988, which was in the process of being prepared, would address those issues in a systematic and comprehensive framework, through the creation of a number of consensus-building and planning mechanisms to ensure that, when the program was put in place, it would be implemented and the process of adjustment would be orderly. That effort was very important, given the need for an increase in the number of jobs for the rapidly growing labor force, including especially younger persons. To that end, they were focusing on the preservation of the development and diversification drive, which had been initiated in the 1970s, following the rise in national income stemming from favorable oil prices and the management of the transition of the economy to substantially lower levels of external income. The authorities were confident that the policies and programs being developed would progressively remove the internal and external imbalances and would reignite the growth process in Trinidad and Tobago.

There was a general desire in Trinidad and Tobago to promote private sector initiatives as a part of the growth effort, Mr. Hospedales commented. That effort would require, of course, not only continued economic investment, but also substantial social investment. His authorities were therefore determined to stimulate domestic savings and to create and maintain the conditions needed for the incorporation of international capital, which was a key requirement if Trinidad and Tobago was to adjust and grow simultaneously. In that connection, the reform of the public enterprises, including divestment where appropriate, and the strengthening of the bank and nonbank financial sectors to ensure their continued viability were also crucial. Those goals were to be achieved through the improvement of the institutional and regulatory policy framework, with a view to preventing the recurrence of the problems that had led to the vast overhang of nonperforming portfolios and the claims on public resources in the past. The authorities hoped that, in the final analysis, the strong self-imposed policy framework that was being developed would meet with appropriate, corresponding, and supportive policies in the international financial community, including the World Bank, which should review the degree and conditions for Trinidad and Tobago's access to bank resources; the level of per capita income should not be the overriding factor.

The Acting Chairman made the following summing up:

Directors were in broad agreement with the thrust of the appraisal in the staff report for the 1987 Article IV consultation with Trinidad and Tobago.

Directors commended the authorities for the efforts that had been made to counter the effects of the sharp decline in the price of oil in 1986. They observed that corrective measures taken since the end of 1986 in the budgetary, wage, and exchange rate fields had helped to contain the deterioration in the fiscal and the external accounts. However, they noted with concern the very large contraction of real GDP which was expected to continue in 1987 for the fifth consecutive year. In addition, they noted that the rates of inflation and unemployment would rise. Directors, therefore, stressed the need to implement promptly a comprehensive program of economic adjustment and structural reform to improve Trinidad and Tobago's balance of payments position over the medium term and lay the basis for economic recovery. Directors underscored the urgency of this task in view of the size of Trinidad and Tobago's imbalances.

In the fiscal area, Directors stressed that a strengthening of the public sector's savings performance through changes in expenditure policy was needed to make room for a rise of public investment. In this connection, Directors urged the authorities to act quickly on their plan to restructure the public enterprise sector to enhance efficiency and capital restructuring and, where appropriate, divestment. In addition, Directors encouraged the authorities to maintain a restrained wage policy and to adjust employment levels within the public sector with a view to improving productivity and reducing the scope of fiscal operations.

Directors were of the view that government revenues should be strengthened through structural changes in the tax system, as well as administrative reforms. In this regard, they noted that the establishment of a broad-based sales or value-added tax to replace the existing spectrum of purchase taxes on domestic goods, as contemplated by the authorities, could be expected to have beneficial effects on the efficiency of the tax system.

Directors observed that a restrained credit policy to protect the Central Bank's net international reserve position was called for. The implementation of such a policy has been complicated by the weaknesses in the financial system and the high cost of financial intermediation, and Directors therefore called for urgent reform of the financial sector, including enhanced banking supervision, and the promotion of competition among financial institutions. Several Directors also stressed that the Central Bank should not become a permanent source of lending to the financial system. They further recommended that actions be taken to encourage upward flexibility of interest rates.

In the external sector, Directors noted the difficult balance of payments outlook over the medium term, especially with the projected sharp rise in debt service payments. While welcoming the unification of the exchange rate system in January 1987, they emphasized that further improvements in competitiveness, and flexible management of the exchange rate and domestic prices were needed to compensate for the recent significant loss in export earnings. Directors stressed that exchange rate flexibility, a rationalization of import tariffs and exemptions, the liberalization of foreign direct investment, and a dismantling of exchange and import controls would help encourage private sector activity, bring about a diversification of the economy, and strengthen the balance of payments. Noting Trinidad and Tobago's external financing needs in the years ahead, several Directors stressed the important contribution which World Bank lending could make in helping Trinidad and Tobago overcome its present structural problems, and strengthen its longer-term growth potential.

It is recommended that the next Article IV consultation be held on a standard 12-month cycle.

APPROVED: May 19, 1988

LEO VAN HOUTVEN
Secretary