EBS/86/248
Supplement 1

CONFIDENTIAL

December 2, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Dominica - Structural Adjustment Arrangement

Attached for the records of the Executive Directors is the text of the structural adjustment arrangement for Dominica agreed at Executive Board Meeting 86/188, November 26, 1986.

Att: (1)

Dominica--Structural Adjustment Facility--
Three-Year and First Annual Arrangements

Attached hereto is a letter, with an annexed Policy Framework Paper and an annexed Memorandum of Economic Policies, dated October 31, 1986, from the Prime Minister and Minister of Finance, Economic Development and External Affairs of Dominica, requesting from the Fund a three-year structural adjustment arrangement and the first annual arrangement thereunder, and setting forth

(i) the objectives and policies of the program to be supported by the three-year arrangement, and

(ii) the objectives and policies of the program to be supported by the first annual arrangement.

To support these objectives and policies, the International Monetary Fund grants the requested arrangements in accordance with the following provisions and subject to the Regulations for the administration of the Structural Adjustment Facility:

1. For a period of three years from November 26, 1986, Dominica will have the right to obtain three successive loans from the Fund under the Structural Adjustment Facility in a total amount equivalent to SDR 1.88 million.

2. The first loan, in an amount equivalent to SDR 0.8 million, is available for disbursement at the request of Dominica.

3. The second and third loans will be available upon approval by the Fund of the corresponding annual arrangements and will be disbursed at the request of Dominica. The amount of the second loan will be equivalent to SDR 0.54 million, and the amount of the third loan will be equivalent to SDR 0.54 million.

4. Before approving the second annual arrangement, the Fund will appraise the progress of Dominica in implementing the policies and reaching the objectives of the program supported by the first annual arrangement, taking into account primarily:

(a) the indicators specified in Table 2 attached to the Memorandum of Economic Policies annexed to the letter dated October 31, 1986,

(b) imposition of restrictions on payments and transfers for current international transactions,

(c) introduction of multiple currency practices,

(d) conclusion of bilateral payments agreements which are inconsistent with Article VIII,

(e) imposition or intensification of import restrictions for balance of payments reasons.

5. In accordance with paragraph 23 of the Memorandum of Economic Policies annexed to the letter dated October 31, 1986, Dominica will provide the Fund with such information as the Fund requests in connection with the progress of Dominica in implementing the policies and reaching the objectives supported by the first annual arrangement.

6. In accordance with paragraph 3 of the attached letter, Dominica will consult with the Managing Director on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because he considers that consultation on the program is desirable. These consultations may include correspondence and visits of officials of the Fund to Dominica or of representatives of Dominica to the Fund.

Dominica - Letter of Transmittal,
Request for Three-Year Arrangement and the
First Annual Arrangement Thereunder

Roseau, Dominica

October 31, 1986

Mr. Jacques de Larosière
Managing Director
International Monetary Fund
700 - 19th Street, N.W.
Washington, D.C. 20431

Dear Mr. de Larosière:

1. The annexed Policy Framework Paper has been prepared in collaboration with the staff of the Fund and the World Bank. It describes the major economic problems and challenges facing Dominica; the objectives of a three-year medium-term program; the priorities and the broad thrust of macroeconomic and structural adjustment policies; and the likely external financing requirements, together with the available sources of such financing.

The Government of Dominica will remain in close contact with the staff of the Fund and the World Bank on developments and progress in implementing these policies, and the Policy Framework Paper will be updated annually as the program is implemented.

2. The annexed Memorandum of Economic Policies pursuant to the policy framework described above sets out the objectives and policies that the Government of Dominica intends to pursue for the period July 1, 1986 to June 30, 1989, and the objectives and policies for the first year of this period, for which balance of payments assistance is needed. In support of these objectives and policies, Dominica hereby requests a structural adjustment arrangement from the Fund for a period of three years in the amounts that will be available to Dominica under the Fund's Structural Adjustment Facility, and the first annual arrangement thereunder.

3. Government believes that the policies set forth in the annexed Memorandum are adequate to achieve the objectives of its program but will take any further measures that may become appropriate for this

purpose. Dominica will consult with the Managing Director on the adoption of any measures that may be appropriate, at the initiative of the Government of Dominica or whenever the Managing Director requests such consultation.

Sincerely yours,

M. Eugenia Charles
Prime Minister and Minister of Finance,
Economic Development and External Affairs

Annexes: Policy Framework Paper
Memorandum of Economic Policies

Dominica - Policy Framework Paper

I. Background

1. Dominica 1/ is a small mountainous island (750 sq. km. and 84,284 population) with an economy primarily based on agriculture. Its principal resources are its largely unexploited tropical forests and its many swift rivers with potential for hydro-power and export of potable water. Economic development has been constrained, however, by inadequate infrastructure, limited skilled and managerial manpower and frequent natural disasters such as hurricanes, floods, and windstorms. Moreover, the rugged terrain contributes to the high cost of providing public services and developing and maintaining infrastructure.

2. Dominica has a sizeable agricultural export sector, consisting mainly of bananas, citrus fruits, and coconut products (agricultural crops are 22.5 percent of GDP at factor cost). However, the high cost, low productivity and quality of bananas and citrus fruits relative to other exporting countries have constrained the growth of these exports. As a result, Dominica has been exporting bananas only to the preferential U.K. market and has virtually lost its major U.K. market for citrus fruits to competitors. A small manufacturing sector (7 percent of GDP), consisting mainly of agro-based industries and some enclave industries is oriented toward exports, primarily to the CARICOM region. Notwithstanding various incentives and institutional support from the Government, the growth of manufacturing has been hampered by inadequate infrastructure and local entrepreneurial talent, especially with regard to marketing, and in the past two years also by increased economic difficulties and trade restrictions within the CARICOM region. The tourism sector is small, only 1 percent of GDP. Dominica does not have significant white sand beaches but offers other natural tourist attractions which could be appealing to cruise-ship passengers and excursionists. However, it has limited tourist infrastructure and management skills and has not been effectively engaged in tourist promotion.

3. Dominica's economic performance is characterized by low production and productivity, structurally weak public finances and balance of payments, and heavy dependence on external assistance. The resource gap in 1984 was some 25 percent of GDP; and though the tax burden is high, Government's savings are inadequate to cover its investment and debt obligations. In 1984 and 1985, concessional external assistance represented some 20 percent of GDP. The unemployment rate is estimated at 15-20 percent.

4. The challenge for Dominica is to enhance productivity in its traditional sectors and to diversify its productive base, expanding nontraditional agriculture, developing secondary activities from its

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1/ Dominica is a member of the Caribbean Community (CARICOM) and the Eastern Caribbean Central Bank (ECCB).

agricultural and other natural resources, developing its tourism potential and attracting labor-intensive light manufacturing. Given the country's small size and development constraints, a sustainable long-term rate of economic growth would depend crucially on Dominica's ability to raise investment and exports. However, given the country's limited financial resources and limited scope for rapid increase in the level of domestic savings, Dominica will continue to require substantial inflow of foreign capital, mainly on concessionary terms, to carry out its public investment programs. In addition, it is expected that appropriate government policies and programs should encourage increased private capital inflows, thus permitting a reduction in the share of foreign capital from official sources. Nevertheless, exogenous adverse developments or natural disasters could call for increased official external assistance to Dominica.

II. Recent Developments

5. After recovering strongly in 1980-81 from the damage caused by the 1979 hurricane, real GDP rose at an average annual rate of close to 3 percent in 1982-85. While agriculture and manufacturing contributed to this growth, much of it is attributable to the reconstruction and rehabilitation investments including investments in the major roads program financed with external assistance, including IDA. In 1982-85, wages increased significantly faster than consumer prices, although the rate of increase moderated in comparison to previous years.

6. Productive sector performance has been mixed. Agricultural output has still not recovered the prehurricane level, in part, because of marketing difficulties and low rates of return to farmers; despite substantial financial and technical assistance to the banana industry (the mainstay of the economy), production continues to lag behind potential. The small manufacturing sector, which showed encouraging signs of growth in 1982 and 1983, stagnated in the following two years with the closure of two garment factories and contraction of soap production primarily because of the economic difficulties in the CARICOM region, their main market. Tourism, by contrast, recovered, benefiting from infrastructure improvements and economic recovery abroad. As a result of contraction in the manufacturing sector, the already acute unemployment situation worsened.

7. The reconstruction efforts were accompanied by stabilization programs, supported by financial arrangements from the Fund, which brought significant improvements in the public finances. This was achieved by strict containment of recurrent expenditure and a rigorous tax effort. The overall deficit of Central Government narrowed from 8.5 percent of GDP in FY 1980/81 to an estimated 1.8 percent of GDP in FY 1985/86 (fiscal years beginning July 1). Over the same period, Government's current balance moved from a deficit of 10.2 percent of GDP to an estimated surplus of 1.2 percent, reflecting expenditure restraints and revenue measures. Also, the public enterprises, which had been a drain

on the budget, have required virtually no transfers from Central Government since FY 1981/82, reflecting better expenditure controls, regular reviews of their pricing policies, and a strengthening of management. Despite these improvements, there has been slow response from the rest of the economy, particularly with regard to investment and exports. As a consequence, Government's ability to generate public sector savings has been limited; and public sector investment (22.0 percent of GDP in FY 1985/86) has had to be financed almost entirely with external assistance. Further, in order to meet its financing needs, Government has required program assistance from abroad and has borrowed from the regional central bank up to the limit of its entitlement.

8. The current account deficit of the balance of payments (including official transfers) narrowed from about 21 percent of GDP in 1981 to 6 percent of GDP in 1985, reflecting mainly the decline in the ratio of imports to GDP but also a recovery of exports from the low level of 1979-80 and a rise in transfers. However, the volume of traditional agricultural exports (bananas and citrus fruits) has not yet recovered the prehurricane level, while manufacturing exports--after rising rapidly in 1981-83--were depressed in 1984-85 by adverse developments in the Caribbean region, as mentioned earlier. The value of imports, which fell in 1981-83, increased sharply in 1984 with the implementation of the road rehabilitation program; it rose moderately in 1985. Tourism recovered the prehurricane level in 1984 but fell back by an estimated 4 percent in real terms in 1985. In 1981-83, the current account deficit was financed mainly by concessionary loans and drawings on the Fund; in 1984-85, concessionary loans and private sector capital inflows more than covered the current account deficit and Dominica made net repayments to the Fund, amounting to US$1.8 million.

9. Dominica's development efforts in the last few years involved a rapid accumulation of external debt which almost doubled between 1981 and 1985. At US$48.5 million, the debt now represents a ratio of 1.27 in relation to exports of goods and nonfactor services (51 percent of GDP). While the average terms are concessional, debt service, including service of IMF debt, is 11 percent of exports of goods and nonfactor services (9.4 percent of exports of goods and services and net private transfers). Because of the institutional arrangements, which limit the macroeconomic policy instruments available to Dominica, a more appropriate indicator of the debt burden is its impact on Government's finances. In 1985, external debt service represented some 15 percent of government current revenues, and the ratio of outstanding external debt to government revenues was 1.66.

III. Medium-Term Objectives

10. Government's medium-term economic objective is to achieve a sustainable rate of economic growth with a view to reducing unemployment, and improving living standards, while strengthening the country's fiscal and balance of payments positions. Thus, the proposed program for

FY 1986/87 to FY 1988/89 seeks to increase private investment and exports, to contain the public external debt burden within manageable proportions, and to strengthen the potential for increased domestic savings.

11. More specifically, the proposed three-year program is aimed at raising the annual rate of growth of real GDP from an estimated 1.1 percent in 1985 to about 4 percent in 1986-88. (Population growth averaged 1.4 percent per annum in 1980-84.) As outlined in Section IV below, the program will develop appropriate incentives and facilities to stimulate private sector investment, both domestic and foreign, thus promoting the growth of output and employment. This would require that the public sector investment program be of high quality and at a level appropriate to support strong growth in agriculture, manufacturing and tourism. A key element of the structural adjustment program will be a strengthening of the fiscal position in the medium term partly through a gradual increase in government savings in relation to GDP, as discussed in Section IV below. Together with operating improvements envisaged for the public enterprises and improvements in private sector savings, domestic savings are expected to rise further. In the period 1985-88, the balance of payments would be strengthened through the growth of merchandise exports and tourism, and the current account deficit would be reduced in relation to GDP by some 4 percentage points if official transfers are excluded but will remain around 6 percent of GDP if official transfers are taken into account.

IV. Medium-Term Economic Strategy and Policies

12. Government believes that the thrust of economic growth in the country should come from the private sector activities, and it actively encourages foreign private investment in order to supplement Dominica's scarce entrepreneurial talent, skilled manpower and capital, and to encourage the introduction of appropriate technology. In this context, the role of the public sector is to create conditions for private sector activities mainly through provision of adequate infrastructural and institutional support, and of incentives for savings and investment. Public sector involvement in new directly productive activities would be limited to projects that would help in achieving the country's medium-term economic objectives and are not likely to be started by the private sector.

a. Macroeconomic Policies

13. Government recognizes the importance of an appropriate macroeconomic policy framework for economic growth. However, the construction of such a framework has to take into account the exchange, trade and monetary policies that are consistent with Dominica's membership in the CARICOM and the common central bank, the Eastern Caribbean Central Bank (ECCB). Although the real appreciation of Dominica's currency in recent years raises questions about the appropriateness of the present exchange

rate, Government believes that exchange rate action is not a realistic option in view of the sharp differences in the movement of the real effective exchange rate among ECCB member countries, and the consequent difficulty of reaching the required unanimous agreement on a rate adjustment. An appropriate incomes policy thus acquires central importance as an instrument for maintaining Dominica's international competitiveness, and the Government is in the process of drafting new legislation for the conduct of wage negotiations in the Civil Service and in the rest of the public sector. In addition, Government expects to bolster the country's competitive position by intensifying its efforts to improve agricultural productivity and by expanding incentives for exports through improved marketing arrangements and measures such as the removal of export taxes on agricultural products. Government will also continue to review periodically exchange rate developments with other members of the ECCB.

14. Monetary policy is carried out within the framework of the regional monetary arrangement. Except for a minimum interest rate of 4 percent on savings deposits established by the ECCB in January 1985, interest rates are determined freely in the market. To improve the efficiency of the banking system, Government recently eliminated the tax on commercial banks' savings deposits and withdrew concessions to the government-owned commercial bank. In addition, Government has taken measures to remove the tax on all bank deposits.

15. Similarly, the fiscal incentives for investment are expected to conform broadly to the "harmonized" system of fiscal incentives within CARICOM; however, within this constraint, Government has already introduced measures to expand incentives for export-oriented investments, and is considering ways to identify and remove disincentives to further growth in investment.

16. Given the above constraints on economic policies in Dominica, the overall policy framework will focus on the strengthening of the fiscal situation and pursuing a prudent wage policy. In this context, subject to the overall requirements of the structural adjustment program, Government will aim at increasing its savings gradually from an estimated 1.2 percent of GDP in FY 1985/86 to 2-3 percent of GDP by FY 1988/89. This effort will focus mainly on expenditure restraint given that as a result of several revenue measures taken in the past five years, the ratio of current revenue to GDP is already high (an estimated 31.8 percent of GDP in FY 1985/86). The growth of the wage bill, which in FY 1985/86 was 57.7 percent of recurrent expenditure, will be contained. Government will examine areas such as the merit increase system, the level of public employment, and rationalization of the civil service with a view to increasing its productivity and to developing a time-phased action program. (The present wage agreement with the civil servants will expire in June 1988.) It will be necessary also to analyse the structure of expenditures to determine where savings could be made so as to limit growth of outlays on goods and services and other current expenditure. On the revenue side, the plan is to

strengthen the tax collection procedures and to rationalise the tax structure. These policies are expected to allow the Government to reduce its reserve liabilities over the medium term, thereby providing for a reconstitution of the needed cushion of borrowing capacity against adverse external developments.

17. While considerable progress has been made in recent years in improving the performance of the public enterprises, further steps will be taken to streamline their operations, particularly the Central Water Authority and the marketing boards. In this context, Government intends to revise water and electricity rates as part of an overall reorganisation and expansion program, and will continue to review the pricing policies of other public enterprises. Also, given Government's policy of limiting public sector involvement in economic activity, it is seeking to divest itself of the electricity company in which it became a majority shareholder in 1983.

18. The planned strengthening of the public finances will enable the domestic commercial banks to accommodate a growing volume of credit to the private sector while preserving their liquidity position.

19. Pursuit of these overall economic policies, together with the sectoral development policies described below, can be expected to result in expanding exports, sustaining a higher level of imports than otherwise and in a strengthening of Dominica's balance of payments position in the medium term. Thus, Dominica will be expected to improve its reserve position while meeting its external debt obligations.

b. Sectoral Policies

20. The main objectives of the sectoral policies are to enhance productivity in Dominica's traditional sectors, to diversify and expand the agricultural base, to provide infrastructural and institutional support for private investment in manufacturing and tourism, and to improve the marketing arrangements for exports. To these ends, the level and composition of the public sector investment program and incentive policies for the key sectors are central to the medium-term program.

21. The chief objective in agriculture is to revive the lagging traditional crops of bananas and citrus fruits. In addition to actions already taken to improve the operations of the banana industry, thus reducing production costs, Government is now focusing on feeder roads, and farm access roads, field packing and other measures to enhance productivity and increase returns to producers. It will intensify efforts, which have met with some success recently, to secure export outlets for citrus fruits and products. In order to exploit the new export opportunity, Government plans to accelerate the pace of the citrus rehabilitation program and to restructure the Co-Operative Citrus Growers Association. Government has promoted also the development of nontraditional crops by establishing a tree-crop diversification scheme, the planting phase of which was completed in 1985. The success of these

diversification programs depends on how quickly export markets and shipping facilities are established. Further, in order to increase land utilization and create employment, credit is to be made available to small farmers within the framework of an integrated rural development project with external assistance.

22. Government also intends to open up some 5,000 acres of forest lands with potential for large-scale development in floriculture, coffee and citrus. This will require about eight miles of new roads and upgrading about seven miles of existing agricultural roads that will also provide direct access to the proposed new airport facilities.

23. Dominica's strategy to develop manufacturing has focused on the establishment of agro-processing such as timber and coconut products, utilizing the country's low-cost labor (relative to neighboring countries), agricultural and other natural resources. Strong efforts are also being made to attract export-oriented light manufacturing such as garments and electrical appliances. The industrial development efforts need to be re-examined with a view to targeting extra-regional markets in light of the unsatisfactory performance of manufacturing stemming from weakness in the Caribbean market in the past two years, and the country's limited success in attracting and retaining foreign private investment. The problems that led two recently established firms to close down have to be addressed. In the meantime, Government will continue to provide adequate fiscal incentives to facilitate an expansion of bank credit to the private sector, to promote wage restraint in the economy through continued moderation in public sector wages, and to extend technical and infrastructural support through the Industrial Development Corporation and the Agricultural Industrial and Development Bank. To facilitate the administration of fiscal incentives, Government intends to establish an export processing zone in an area already identified for the relocation and upgrading of present airport facilities in the North of the Island. Government also intends to strengthen the institutional support for the promotion of industry and tourism by reorganizing and integrating the present Industrial Development Corporation and the Tourist Board into one organization--The National Development Corporation--in order to improve the capability for identifying, appraising and presenting investment proposals.

24. Dominica's tourism could play a larger role than in the recent past in creating employment and strengthening the country's foreign exchange earnings. Since some of the major road rehabilitation work has been completed, the Government proposes to reconstruct access roads to the main tourist attractions and to direct promotion efforts toward special target groups and tour operators in the region. Dominica is participating in the development of a joint program with St. Christopher and Nevis, and St. Vincent and the Grenadines, which would offer special tourist programs covering all three countries in one package.

25. The inadequacy of Dominica's infrastructure is an increasingly critical factor in the further development of the productive sectors and

infrastructural requirements will be examined carefully in the context of the medium-term public sector investment program. The Government intends to build farm access roads to enhance the productivity of the banana and citrus industries. In order to encourage investment in manufacturing, Dominica assigns priority to a proposed hydro-electric project as a source of indigenous power and the establishment of adequate airport facilities. Government is concerned that the absence of international airport facilities could be a major deterrent to expansion in investments and exports.

While it may not be economically or financially viable to establish full-fledged international airport facilities immediately, it is essential that present facilities be upgraded to facilitate more regular and frequent traffic, including air cargo transport and safer all-weather conditions. Government intends to relocate the present airport at Melville Hall to an area already identified and surveyed that will allow safer traffic conditions, including nightlanding facilities, and that will have the potential for further development in the longer term. This new facility will be central to the development and expansion of agriculture, tourism and manufacturing in the area with the greatest potential. Dominica's export-oriented strategy emphasises the need to alleviate the deficiencies of existing sea and air transport facilities, including infrequency of shipping schedule, inadequacy of air cargo facilities, and transshipment problems for marketing of nontraditional exports, such as exotic fruits, ornamental foliage and certain manufactured goods. In the interim, Government is cooperating with other OECS governments to develop joint marketing arrangements. It would be possible to advance along all these fronts in the context of a rational PSIP, provided the required level of external assistance would be forthcoming.

V. External Assistance Requirements (FY 1986/87-FY 1988/89)

26. Dominica's external assistance requirements are related mainly to the public sector investment program which is designed to foster the economic objectives stated earlier. In recent years, public sector investment has emphasised support for directly productive activities and economic infrastructure. This focus will continue over the medium term as the economic diversification efforts proceed and investments are directed at meeting the infrastructural requirements for a growth-oriented economy. In addition, efforts will be intensified to improve Dominica's administrative capability so that it can reduce the heavy dependence on external assistance in the management of the PSIP.

27. In addition, discussions at the subgroup meeting for Dominica chaired by the World Bank in St. Lucia last March indicated that Dominica's development efforts would need to be supported by program-type assistance over the next three years. Indications are that about US$12 million in nonproject external assistance can be expected over the three-year period. The IMF would provide assistance of SDR 1.9 million

under the Structural Adjustment Facility arrangement. Also, the World Bank is considering a structural adjustment credit for about US$3 million from IDA. The U.S. AID and other donors are likely to provide program assistance to Dominica at the level of US$7.5 million. The World Bank is also considering co-financing of the proposed hydro-power project with IDA funds of US$3 million, and possibly some additional assistance from IDA 8 which would be blended with IBRD funds (depending on the Bank's assessment of Dominica's creditworthiness) in the final year of Dominica's three-year adjustment program. All these operations can also serve to attract financing from other sources. While it is expected that, with adequate levels of external financing and appropriate policies and programs, Dominica's economy would be strengthened, the constraints inherent in the country's physical structure and the susceptibility of the productive structure to devastation by natural disasters may affect the pace of attainment of external viability. Thus, Dominica's dependence on concessional external assistance may persist beyond the medium-term, albeit at reduced rates.

28. Preliminary estimates suggest that total external assistance requirements of Dominica over the next three years would average about US$24 million annually, or about 21 percent of the projected GDP. The bulk of this assistance would be project-related, with nonproject assistance requirements accounting for about 17 percent of the total. The public sector investment review, which will soon be completed in collaboration with the World Bank in the context of the medium-term adjustment program, will provide firmer estimates of the external financing requirements for the second and third years of the program.

29. Government has made efforts to make the proposed medium-term PSIP realistic but this will be reviewed at the beginning of each annual program. In addition, the PSIP may need to be modified during the course of the annual program periods to take account of unforeseen developments. If any new projects are to be added, Government will ensure that they are of the highest priority for promoting growth and are also consistent with the achievement of Dominica's medium-term economic objectives as set out in this paper. Nonconcessionary financing for these new projects may be considered, but only where cash flows resulting from the projects will assure the servicing of the additional debt, keeping the overall debt burden within manageable limits. In each such instance, Government will first consult and reach understanding with the staff of the World Bank and the Fund before the initiation of any such project.

30. In view of Dominica's limited capacity to implement projects and programs, technical assistance has played a significant role in the country's development efforts and will continue to do so for some time. In order to ensure successful implementation of the medium-term adjustment program, the technical assistance requirements will have to be investigated and provided in a timely manner.

VI. Social Impact

31. The adjustment measures envisaged in the program are designed to increase the rate of growth of output and employment in the economy, with the private sector playing a leading role. The proposed improvements in agriculture sector pricing policies and institutions are designed to effect higher producer prices, thus increasing farm incomes; and the Government's land distribution and settlement program will increase access of the low-income rural population to productive assets. Since Dominica is largely a rural society of predominantly small farmers, the benefits are likely to be widely spread.

32. While the rationalization of the civil service may, in the short term, result in retrenchment in government employment, it is expected to be offset by increased employment opportunities in the private sector. In the absence of a flexible exchange rate policy instrument, wage restraint is particularly needed to ensure Dominica's international competitiveness and profitability of investment. Because of its leading role in the determination of wages in the economy, restraint on the increase of government pay would be important to achieve this objective. Moreover, such a restraint would help in narrowing the income distribution gap between public sector workers and the rest of the labor force, particularly in agriculture.

Attachment

Dominica - Selected Data

Area	750 sq. kilometers
Population (1985)	84,284
GDP (1985)	US$95.2 million
GDP per capita (1985)	US$1,130

Origin of GDP (1985)	(In percent)
Agriculture and mining	29.9
Manufacturing	7.2
Construction and utilities	10.1
Transport and communication	13.9
Government services	23.5
Other	15.4

Ratios to GDP (1985)	
Government current revenue 1/	31.8
Government current expenditure 1/	30.6
External current account balance before grants	-21.4
External current account balance	-6.0
External public and publicly guaranteed debt (end of year)	50.9

	1982	1983	1984	Prel. 1985
	(Annual percentage changes)			
Real GDP (at factor cost)	2.4	2.1	6.2	1.1
Nominal GDP at market prices	9.1	9.7	11.2	8.2
Consumer prices (annual averages)	4.4	4.1	2.2	2.1

	1982/83	1983/84	1984/85	1985/86
	(Millions of Eastern Caribbean dollars)			
Central government finances 1/				
Current account balance	-4.9	0.2	0.1	3.1
Overall balance after external grants	-15.7	-13.7	-15.2	-4.7
Overall balance after external grants and concessionary loans	-8.5	-2.3	-3.4	-3.5
Borrowing from ECCB (net)	--	2.0	2.1	4.8

	1982	1983	1984	Prel. 1985
	(Millions of U.S. dollars)			
Balance of payments				
Merchandise exports (f.o.b.)	24.5	27.5	25.6	28.4
Merchandise imports (c.i.f.)	-47.5	-47.1	-55.8	-57.2
Balance on current account 2/	-8.8	-6.0	-3.9	-5.8
Official borrowing (net)	8.2	5.3	4.7	4.5

1/ Refers to fiscal years beginning July 1.
2/ After external grants.

Memorandum of Economic Policies

1. The Policy Framework Paper (PFP), which the Government of Dominica prepared in collaboration with the staff of the IMF and the World Bank, describes the major economic problems and challenges facing the country, the objectives and priorities of the program for the period FY 1986/87-FY 1988/89 (fiscal years beginning July 1), and the broad thrust of macroeconomic and structural adjustment policies. This memorandum is intended to provide a more detailed description of the policies contained in the economic program, with emphasis on the first year of the program.

2. As noted in the PFP, the economy of Dominica made significant gains in the years following the hurricanes of 1979-80. Real GDP recovered its prehurricane level in 1981, and expanded in 1982-85, albeit at a slower pace. During this period, the rate of inflation declined substantially, the external current account deficit narrowed, and the public finances improved. However, the unemployment rate continues to be high; traditional exports remain below their prehurricane levels and new manufacturing exports were depressed in the past two years, partly due to increased economic difficulties in the Caribbean Community (CARICOM) region; the ratio of imports to GDP has declined over the last five years; and public sector investment has been dependent almost entirely on external financing.

3. Government's medium-term economic objective, elaborated in paragraphs 10 and 11 of the PFP, is basically to achieve a sustainable rate of economic growth, while strengthening the country's fiscal and balance of payments positions. The thrust of economic growth would come from the private sector activities, and the main role of the public sector will be to create conditions for such activities. Accordingly, the policies are designed to achieve annual rates of growth of real GDP of 3 1/2 to 4 percent in 1986-89 (up from 1.1 percent in 1985), with agriculture, agro-industries, and manufacturing as the leading sectors. In addition, the proposed program would seek to increase private investment, exports, and the potential for domestic savings, to contain the public external debt burden within manageable proportions, and to build up a cushion of reserves to meet adverse external shocks. Government believes that without the support for its program from the IMF and the World Bank, the growth of real GDP over the medium term would be negligible as donor-supported public investment would be reduced sharply and some crucial structural reforms would be delayed (the major indicators and parameters of the three-year economic program are presented in Table 1).

The public sector investment program

4. The public sector investment program (PSIP) for FY 1986/87 to FY 1988/89, which is being finalized for the last two years of the program with assistance from the major donors, the Inter-Agency Resident Mission, the Caribbean Development Bank, and the World Bank, is

consistent with the economic objectives of Government. During the program period, the links between public sector investment, savings and economic growth would be strengthened through improvements in the management of the public enterprises and government departments (particularly the tax administration) and through the pursuit of an appropriate rate structure for public utilities. As the PSIP places a heavy emphasis on the rehabilitation, as opposed to expansion, of the existing infrastructure in the early part of the three-year program, its impact on government recurrent expenditure will be small, and Government has made provisions in the budget to cover these expenditures. In relation to total public sector capital outlays over the three-year period, about 23 percent would be allocated mainly to the provision of agricultural inputs and credits and the construction of farm and tourist access roads; about 54 percent would be assigned to economic infrastructure, and the rest to social services and public administration.

5. Under the PSIP, capital outlays are projected to decline from an estimated 22.0 percent of GDP in FY 1985/86 to 21.2 percent of GDP in FY 1986/87, because of the completion of the major road projects by mid-1986. The PSIP for FY 1986/87 includes outlays of EC$8.6 million, equivalent to 3 percent of GDP, on a water export project which will be undertaken only after appropriate marketing and transportation arrangements with potential buyers have been made. Total capital spending is projected to average about 20 percent of GDP in the last two years of the program. The PSIP for the first year of the program includes only those projects which are currently in progress or for which sources of financing have been identified. In the last two years of the program about 8 percent and 40 percent, respectively, of the projected capital expenditure relate to projects which require additional preparation before implementation and have no identified source of financing. About 84 percent of the public sector investment in FY 1986/87 is to be financed by project-related external grants and loans (mostly on concessionary terms), but Government hopes that this percentage would rise to 86 percent and 90 percent, respectively, in FY 1987/88 and FY 1988/89.

The operations of the Central Government

6. The new budget contained a tax package which is expected to yield additional revenue of EC$1.4 million (0.5 percent of GDP) in the first year of the program. The package included (estimates of revenue impact are indicated in parentheses): (i) the removal of export tax (-EC$0.2 million); (ii) the removal of stamp duty on export sales (-EC$0.2 million); (iii) the reduction in the foreign exchange levy from 2 1/2 percent to 1 1/2 percent (-EC$0.4 million); (iv) the reduction in company profit tax from 45 percent to 30 percent for manufacturing firms, effective January 1, 1987 (-EC$0.8 million); (v) the removal of tax on bank deposits (-EC$0.3 million in FY 1987/88); (vi) an increase in consumption tax on imports of motor vehicles (EC$1.2 million); (vii) an increase in tax on imports of petroleum (EC$1.1 million); and (viii) increases in various licenses and fees, such as motor vehicle

licenses and professional fees (EC$0.7 million). The foreign exchange levy will be removed on July 1, 1988. The tax package is intended to stimulate manufacturing and exports and to provide a partial offset to the loss of revenue stemming from the reduction in personal income taxes that became effective January 1, 1988. In addition, revenue will be boosted by the recent change in the company tax law which required prepayments of taxes beginning June 1986, and by the recent expiration of the tax-holiday status of a large manufacturing firm. These policy measures and developments would help maintain the ratio of current revenue to GDP at 31.8 percent in FY 1986/87 (see Table 1).

7. Dominica has already implemented an indirect tax reform with assistance from the IMF, and has recently improved the administration of the inland revenue department. In March 1986, Government applied to the Inter-Agency Resident Mission for technical assistance in upgrading the customs valuation system and in monitoring the use of materials imported under the Fiscal Incentives Act. As Dominica's tax burden is relatively high, Government has recently requested external technical assistance to review the overall tax system with a view to reducing disincentives to producers and broadening the tax base. In this context, Government will ensure that the implementation of the tax reform will be consistent with the objectives of strengthening the fiscal position and containing Government's debt burden within manageable limits.

8. In the area of current expenditure, Government has done everything possible to restrain growth, and further reductions are constrained by the small size of the civil service, the current wage contract which expires in June 1988, statutory retiring benefits and interest payments, and by the need to provide for the maintenance of infrastructure and the minimum level of social services. However, reflecting its commitment to expenditure restraint, beginning this fiscal year Government has eliminated the automatic merit increases, which amounted to 2.5 percent of the wage bill in recent years. The recently negotiated reduction in interest rate charges on the outstanding local debts and the decline in nonconcessionary debt will assist in holding down the interest payments. Also, the retiring benefits payments will be reduced to a more normal level in FY 1986/87, partly due to the improvement in expenditure controls that was implemented in the preceding year. However, other expenditures will rise somewhat in real terms reflecting an increase in expenditures on tourism promotion and education, and a rise in the cost of membership in the regional and international organizations. These policies are expected to reduce current expenditure from an estimated 30.6 percent of GDP in FY 1985/86 to 30.2 percent of GDP in FY 1986/87.

9. As a prudent wage policy is essential both for strengthening the fiscal position and for improving the country's international competitive position, Government intends to introduce new legislation by the end of the current fiscal year in order to make wage bargaining procedures less disruptive and to implement a uniform wage policy in the entire public sector. Also, Government will take action on the size of

the civil service by mid-1987 taking into account the recommendations of the organization and management study which is expected to be completed by early 1987, with the assistance from the Inter-Agency Resident Mission. The program has been designed to allow for a 3 percent growth in the wage bill in FY 1988/89, but Government hopes that the proposed actions on wages and employment, together with price stability, may enable it to contain the growth of the wage bill even further.

10. On the basis of the policies just described, the current account surplus of the Central Government is projected to rise from an estimated 1.2 percent of GDP in FY 1985/86 to 1.6 percent of GDP in FY 1986/87. Government's capital outlays are expected to decline from an estimated 16.4 percent of GDP to 13.9 percent of GDP in the same period. However, receipts of external grants are anticipated to decline at a faster pace than capital outlays. The overall fiscal deficit is estimated to widen from 1.8 percent of GDP in FY 1985/86 to 3.8 percent of GDP in the current fiscal year. The deficit is expected to be covered by net concessionary loans (EC$5.3 million), the first disbursement of the Structural Adjustment Facility loan (EC$2.4 million), and nonconcessionary financing (EC$3.2 million). Within the nonconcessionary financing, there would be external loans of EC$8.1 million for the water export project, repurchases of EC$4.2 million to the Fund, contributions of EC$0.7 million to the sinking funds held abroad, and no net borrowing from domestic sources (including the ECCB). During the first half of FY 1986/87 Government would endeavor to limit its use of nonconcessionary financing to EC$2 million.

11. The above indicators will serve as benchmarks for monitoring nonconcessionary financing of the Central Government. If any project in the agreed PSIP were not undertaken, Government will not engage in nonconcessionary borrowing related to that project and, accordingly, the limits on the use of nonconcessionary borrowing will be adjusted downward automatically unless further agreements are reached between Government and the Fund staff. If a temporary need for financing were to arise from unforeseen developments such as delays in aid disbursements, Government may borrow EC$2 million on a net basis from domestic sources, thus increasing the limits on the use of nonconcessionary financing by EC$2 million in the first year of the program. Government will not guarantee any foreign loan on nonconcessionary terms in FY 1986/87. During the three years of the program period, Government will refrain from accumulating domestic or external payments arrears, and will not borrow from foreign sources on nonconcessionary terms (i.e., loans with grant elements of less than 25 percent) except as noted in paragraph 29 of the attached PFP.

12. In the last two years of the program, the ratio of government savings to GDP is projected at 2.1 percent and 2.9 percent, respectively (see Table 1). However, these projections may have to be adjusted later on to take into account the proposed review of the tax system (paragraph 7). Capital outlays of the Central Government are projected to be somewhat lower in the last two years of the program. The overall

deficit is expected to narrow in FY 1987/88 before shifting to a small surplus in FY 1988/89. In those years, the Central Government would reduce its outstanding nonconcessionary debt by about 3 percent of GDP a year, including repurchases to the IMF, accumulation of foreign assets, and net repayments to the local commercial banks. Government will adopt by mid-1987 a budget for FY 1987/88 conducive to attainment of the program's objectives.

The operations of the rest of the public sector

13. Government intends to improve the operations of the public enterprises with a view to increasing their contributions to the country's savings effort and improving the quality of their investments. A law has just been passed completing the process of merging the External Trade Bureau and Agricultural Marketing Board into a single Dominica Export and Import Agency in order to improve their financial position and to help boost agricultural exports. In the current fiscal year, the Central Water Authority (CWA) will be reorganized in order to reduce its operating costs and to strengthen its management. It is expected that in the second year of the program, with external assistance, the CWA will embark on a modernization and expansion plan, including a review of the water charges. On July 1, 1986, the Port Authority increased the port charges by 10 percent in order to help recover the cost of new equipment and to maintain the level of savings achieved in the past two years. Further, Government intends to offer for sale 60 percent of the equity in the Dominica Electricity Services Ltd. during the current fiscal year, with a view to transferring the entire ownership eventually to the private sector.

14. The banana industry has been benefiting from the increased use of field packing, pesticides and fertilizer, the increased acreage under cultivation, and the recent appreciation of the pound sterling (the currency of Dominica's major market for bananas) vis-a-vis the U.S. dollar (to which Dominica's currency is pegged). In addition, the farm access roads are being upgraded with external assistance, which should eliminate the 10 percent production loss arising from the poor condition of these roads. Also, Government is in the process of preparing a plan for further improving the efficiency of the banana industry. These policy measures and the recent exchange rate developments have already yielded a significant increase in return to banana growers in 1985 and in the first half of 1986. As a result, banana exports are projected to rise from 33,000 tons in 1985 to at least 40,000 tons in 1986, 45,000 tons in 1987, and to 60,000 tons by 1990. Therefore, the financial position of the Dominica Banana Marketing Corporation is expected to improve substantially during the 1986-90 period.

15. The Social Security Scheme, which is an autonomous statutory body, would continue to generate a current account surplus in FY 1986/87. This surplus would increase in the last two years of the program, partly due to the expected extension of coverage to the self-employed, beginning July 1, 1987. The surpluses of the Social Security Scheme are, and

will continue to be, invested mainly as deposits with the local financial institutions.

The private sector

16. Government had expanded the fiscal incentives for manufacturing investment in the last fiscal year, including (i) the removal of import duties on all imports of inputs for manufacturing, (ii) a lower rate of custom service charge on these imports, (iii) elimination of tax on savings deposits at local commercial banks, and (iv) a reduction in consumption tax on the domestic production of manufactured goods from a 30-40 percent range to a flat 10 percent rate. In addition, significant improvements have been made in the infrastructure, including a growing stock of factory shells, and in the services of the Industrial Development Corporation (IDC) and the Agricultural and Industrial Development Bank. Over the past five years, Government has helped to maintain stable labor relations, and contributed to a slowdown in wage increases; also, the reduction in the public sector indebtedness to the local commercial banks facilitated an increase in the availability of credit to the private sector.

17. As noted in paragraphs 6 and 7, Government has introduced several tax measures in the new budget and intends to implement further tax reforms during the program period in order to stimulate private sector activities. Also, Government intends to strengthen the institutional support for the promotion of industry and tourism by reorganizing and integrating the present IDC and the Tourist Board into one organization in order to improve the capability for identifying, appraising and presenting investment proposals. Further, Government is examining with the donors a plan to establish a duty-free export processing zone in Dominica.

18. The PSIP would continue to create conditions for the expansion of private sector activities over the medium term. In the agricultural area, the additional policies for increasing banana production are outlined in paragraph 14. In order to stimulate the depressed citrus production and exports, Government established a joint venture, the Dominica Agro-Industries Ltd., which now operates the government-owned agro-processing plant and has recently boosted exports of processed grapefruits; this firm will be made the marketing agent for fresh grapefruits following the reorganization of the Co-Operative Citrus Growers Association by the end of 1986.

19. In the tourist sector, with external technical and financial assistance, Government will intensify tourism promotional efforts abroad during FY 1986/87. In this context, a regional tourism policy is being developed, which would involve selling a multi-island tourist package. Further, as already stated, the IDC and the Tourist Board are expected to be merged by the end of 1986 in order to improve efficiency and reduce cost of their promotional efforts. In addition, the PSIP includes plans for rehabilitation and expansion of access roads to Dominica's tourist attractions.

The financial sector

20. As noted in paragraph 6, Government removed all taxes on deposits at the local commercial banks on July 1, 1986 to stimulate domestic savings and investment. Further, during the program period, the expected improvements in the net creditor position of the public sector with the local commercial banks would enable them to accommodate a growing credit to the private sector without jeopardizing their liquidity position.

The external sector

21. As elaborated in paragraph 13 of the PFP, although there appears to be a real appreciation of Dominica's currency in recent years, exchange rate action is not a realistic option in view of the sharp differences in the movement of the real effective exchange rate among ECCB member countries. The effects of adverse exchange rate developments on Dominica's economy will be alleviated by the recent measures such as the removal of tax on exports, increases in import taxes on certain consumer goods, the expanded fiscal incentives for investment, and the elimination of the tax on deposits at local commercial banks. In addition, the unit cost of production in Dominica is expected to decline because of increases in productivity stemming from improvements in infrastructure and production techniques. However, Government will review periodically the exchange rate developments with other members of the ECCB, and as mentioned earlier, will exercise strict control on public sector wages.

22. During the program period, Government does not intend to introduce any multiple currency practice or impose any restrictions on payments and transfers for current international transactions or, for balance of payments reasons, introduce any new or intensify any existing restriction on imports, and will not enter into bilateral payment agreements with member countries of the Fund.

23. Government will send, by cable, end-period data on summary operations of the Central Government for each month by the end of the following calendar month, and send any other information the Fund may request to monitor the progress under the program.

Table 1. Dominica: Selected Economic Indicators

	1984	1985	Program 1/ 1986	1987	1988
(Annual percentage changes, unless otherwise specified)					
GDP at constant prices	6.2	1.1	4.0	3.5	3.5
GDP deflator	4.4	6.9	3.0	3.0	3.0
Consumer prices	2.2	2.1	2.5	3.0	3.0
Exports (in U.S. dollars)	-6.9	10.9	18.1	14.1	13.2
Imports (in U.S. dollars)	18.5	2.5	14.2	3.1	7.6
Bank credit to private sector 2/	9.0	9.1	16.0	11.4	13.5
(In percent of GDP, unless otherwise specified)					
Balance of payments 3/					
Current account deficit	-4.4	-6.0	-6.6	-7.7	-5.8
Current account deficit before external grants	-21.0	-21.4	-22.4	-18.2	-16.9
External debt	49.1	50.9	52.2	56.0	57.0
Debt service as a percent of receipts from exports, services, and net private transfers	10.1	9.4	9.2	9.5	10.5
Central government operations 4/					
Current revenue	30.1	31.8	31.8	31.6	31.1
Current expenditure	30.1	30.6	30.2	29.5	28.2
Current balance	--	1.2	1.6	2.1	2.9
External grants	14.5	13.5	8.5	7.9	10.7
Capital expenditure and net lending	20.7	16.4	13.9	11.7	13.2
Overall balance	-6.1	-1.8	-3.8	-1.7	0.4
External concessionary loans (net) 5/	4.8	0.5	2.7	4.6	2.6
Nonconcessionary financing	1.4	1.3	-1.1	-2.9	-3.0

1/ Program beginning July 1, 1986.
2/ In relation to commercial banks' liabilities to private sector at beginning of period.
3/ The balance of payments estimates are made with assistance from the Fund staff, and are based on incomplete information.
4/ Refers to fiscal years beginning July 1.
5/ Includes disbursements of the Structural Adjustment Facility loans.

Table 2. Dominica: Indicators for the First Annual Arrangement Under the Structural Adjustment Facility
July 1, 1986 - June 30, 1987

	Time
A. Quantitative Indicators	
1. Government would endeavor to limit its use of nonconcessionary financing to EC$2 million during the first half of FY 1986/87 and to EC$3.2 million in FY 1986/87. If any project in the agreed PSIP were not undertaken, Government will not engage in nonconcessionary borrowing related to that project and, accordingly, the limits on the use of nonconcessionary borrowing will be adjusted downward automatically, unless further agreements are reached between Government and the Fund staff.	During FY 1986/87
2. If a temporary need for financing were to arise from unforeseen developments such as delays in aid disbursements, Government may borrow an additional EC$2 million on a net basis from domestic sources, thus increasing the limits on the use of nonconcessionary financing by EC$2 million.	During FY 1986/87
3. Government will not guarantee foreign loans on nonconcessionary terms.	During FY 1986/87
4. Government will not borrow from external sources on nonconcessionary terms, except as provided in paragraph 29 of the Policy Framework Paper.	In FY 1986/87-FY 1988/89
5. Government will not accumulate domestic or external payments arrears.	In FY 1986/87-FY 1988/89
B. Other Indicators	
1. New wage legislation for the public sector.	By end of June 1987
2. Completion of the management and organization study on the civil service.	By early 1987
3. Implementation of actions on the size of the civil service taking into account the recommendations of the above study.	By mid-1987
4. Reorganization and strengthening of the management of the Central Water Authority.	During FY 1986/87
5. Divestment of Dominica Electricity Services Limited by offering 60 percent of equity shares for sale.	During FY 1986/87
6. Merger of the Industrial Development Corporation and the Tourist Board.	By end-1986
7. Reorganization of the Co-Operative Citrus Growers Association.	By end-1986
8. Government would adopt a budget for FY 1987/88 conducive to attainment of the program's objectives.	By mid-1987