INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/21

10:00 a.m., February 5, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	E. L. Walker, Temporary
	S. Kolb, Temporary
	S. de Forges
M. Finaish	T. Alhaimus
	H. Kobayashi, Temporary
	W.-R. Bengs, Temporary
Huang F.	
J. E. Ismael	
	J. Hospedales, Temporary
	M. Foot
	S. Simonsen, Temporary
	L. Leonard
E. I. M. Mtei	
	M. A. Weitz, Temporary
	J. E. Suraisry
	J. E. Rodrîguez, Temporary
	A. Steinberg, Temporary
	A. V. Romuâldez
G. Salehkhou	
	A. S. Jayawardena
	N. Coumbis

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; J. T. Boorman. Legal Department: J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; E. J. Bell, J. G. Borpujari, P. S. Griffith, S. H. Hitti, Z. Iqbal, H. E. Jakubiak, B. A. Karamali, D. B. Noursi. Research Department: A. D. Crockett, Deputy Director; M. C. Deppler, F. Larsen. Treasurer's Department: R. A. Feldman. Western Hemisphere Department: J.-P. Amselle, J. Ferrán, A. H. Gantt, H. E. Khor, S. J. Stephens. Advisor to Executive Director: G. Nguyen. Assistants to Executive Directors: M. Arif, S. Geadah, G. D. Hodgson, A. R. Ismael, J. M. Jones, R. Msadek.

1. ST. VINCENT AND THE GRENADINES - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with St. Vincent and the Grenadines (SM/85/345, 12/31/85). They also had before them a report on recent economic developments in St. Vincent and the Grenadines (SM/86/9, 1/16/86).

Mr. Leonard made the following statement:

> In the second half of 1984, the Government of St. Vincent and the Grenadines initiated a searching appraisal of the performance of the economy and of related public sector policies. In particular, the Government was concerned by the weakness of the current fiscal account, the heavy financial losses of certain public enterprises, and the drain on the liquidity of the state-owned National Commercial Bank. A further source of concern was the collapse of the arrowroot market which resulted in both a major loss of foreign exchange and a weakening of the agricultural sector, which is still the mainstay of national production. It was clear also that the boost given to agriculture by the attempt to revive the sugar industry, begun in 1980, could not be sustained because of the huge losses of the sugar-refining industry on which it depended.
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> In response to these difficulties, the Government took resolute action to restore fiscal balance, to safeguard the liquidity of the banking system, and to prepare the way for developmental policies that would address national problems of the high level of unemployment and inadequate real incomes.
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> The measures taken to improve the finances of the Central Government in reforming the taxation system, raising revenue, and strictly controlling expenditure are described in the staff report. As a result of these measures, current revenue of the Central Government rose by 2 percentage points of GDP between 1983/84 and 1984/85 while current expenditure fell by an even larger proportionate amount. The current deficit, which had re-emerged as more than a half percent of GDP in 1983/84, was accordingly replaced by savings of 4 percent of GDP in 1984/85.
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> The Government is managing its finances equally firmly in the present fiscal year and intends to do so again in 1986/87. It expects that it will be necessary to increase civil service pay this year but is resolved to keep the increase in the pay bill within single digit percentage figures and to make no retroactive payments despite the fact that civil service salaries have not been increased since June 1984. An increase is seen as particularly necessary at the higher levels in conjunction with a restructuring that will strengthen the managerial capacity of the civil service and enable it to make its proper contribution to national development. Present indications are that even

after the granting of a pay increase, there would again be a current surplus in the fiscal year 1986/87, which would contribute significantly to financing the public sector investment program.

Containment of the large current losses incurred by certain public enterprises since the beginning of the decade required difficult decisions. By far the largest loss makers were Sugar Industry, Ltd., and the Arrowroot Industry Association. Closure of the former, which took place in June of last year, brought significant job losses to a region of the main island that was already debilitated, cut farming incomes, and weakened agricultural production. There were advantages on the national level, however, in that through the sale of imported sugar at the same domestic price as before, it was possible to generate surpluses, which were used in part by the Government to service the debts of the sugar corporation which it had taken over and in part for other national purposes. The Government is also making good the damage to the agricultural sector by encouraging diversification into an expansion of production of other crops for which there are domestic and Caribbean Community (CARICOM) markets.

As regards the Arrowroot Industry Association, it was recognized that the extent of its operations would have to be reduced in the face of the changed market situation. Current losses are still occurring but are much smaller than before and are being met out of sales of stock. The authorities believe that the industry still has a viable though less important role than in the past and that production could profitably continue.

Overall, as a result of the authorities' action the current losses of the consolidated public enterprises have been converted into surpluses in 1985/86 that are expected to be maintained in 1986/87.

Public investment is partly undertaken by the Central Government, and partly by the public enterprises, though the emphasis under the public sector investment program for some time will be on capital spending by the enterprises. As in the past, and even taking account of the greater contribution from public saving that is now possible, the funding of this investment depends for the greater part on capital grants from abroad and on other external financing, mainly on concessionary terms. To avoid planning upsets, however, the Government is seeking to ensure that the necessary funds are available before putting investment proposals into effect. To the extent that external borrowing is involved, the authorities expect that because of the concessionary terms on which, for the most part, it is being undertaken, problems will not arise in servicing it, an expectation which is supported by the staff's medium-term external account projections.

The improvement in the public finances from FY 1984/85 onward has permitted a net reduction in the public sector's net liabilities to the domestic banking system and an increase in its liquidity. Thus, the liquidity ratio of the commercial banking system as a whole fell from 88 percent at end-December 1982 to 86.7 percent at end-December 1984 and further to 84 percent at end-September 1985. For the state-owned National Commercial Bank the improvement was more pronounced, with a fall from 118.8 percent to 106.3 percent, to 95.4 percent on the corresponding dates.

Savings are being encouraged by higher interest rates on bank deposits made possible by an easing of the tax levied on interest-bearing deposits and by removal of the ceiling on interest rates on new loans and a progressive raising of the ceiling on existing loans until it, too, is removed in 1987.

While continuing to cooperate with the Central Bank in its ongoing review of the appropriateness of the present exchange rate of the Eastern Caribbean dollar, the authorities are not convinced that there is a national advantage to be gained from a change in present parity even though the currency has appreciated by about 15 percent since 1980. They believe that producers in the islands already enjoy cost advantages and accept that this has to be preserved, in the absence of change in the exchange rate, by tight management of domestic demand. As part of their efforts in that direction, public sector pay, as indicated above, is being closely contained, and it is the expectation of the authorities that there will be similar containment in the private sector.

Recent estimates suggest that the number of persons without jobs in St. Vincent and the Grenadines is in the range of 35 to 45 percent of the labor force. The Government's development plans aim at reducing these figures through the expansion of private sector activities. Significant growth is expected in manufacturing and tourism, but the authorities expect that while every opportunity to expand these sectors will be availed, agriculture will be the main source of employment for some years to come.

The Public Sector Investment Program is a major instrument of the Government's development efforts. About 13 percent of projected spending under the program will be devoted to the agricultural sector with about the same proportion going to transportation projects and about 11 percent to manufacturing. By far the largest share, nearly half, will go to the Cumberland power project, which is expected to fill an important gap in the infrastructure needed to support new activities. Directly productive projects will be assisted by the provision of factory shells for which there is strong demand. Obstacles in the way of making sites available for the shells have now been cleared away by the Government. The makeup of the program has the endorsement of the World Bank as being in line with the development needs of the islands.

Mr. Hospedales commended the authorities of St. Vincent and the Grenadines for their commitment to economic adjustment and sustained implementation of economic policies adopted since the previous Article IV consultation discussion (EBM/84/119, 8/1/84). Their efforts had undoubtedly contributed to the progress in economic performance that had been highlighted by the staff in its appraisal, the thrust of which he supported. In addition, Mr. Leonard had provided a helpful analysis of the significant efforts being made by the authorities to overcome the structural constraints associated with the problems of development.

Notwithstanding the improvements made in the government and external accounts and in inflation, structural maladjustments in production and trade were proving to be a problem and could jeopardize the attainment of sustained growth and the hoped for reduction in unemployment levels, Mr. Hospedales continued. In 1985, real GDP had grown only 3 percent--the lowest rate since 1981--and unemployement had reached alarming proportions, estimated in the range of 35-45 percent. In the circumstances, his chair welcomed the emphasis the authorities were placing in their development strategy on export promotion and export generation. The focus would be on three key sectors of the economy--agriculture, manufacturing, and tourism--and the authorities were looking toward an early implementation of the public sector investment program, which was considered by the World Bank to be structurally well conceived. He was encouraged to note that financing for the investment program had already been secured on highly concessional terms. In that respect, the positive response of the multilateral and bilateral donor community had been commendable, and it was to be hoped that continuing concessional flows would be made available to help St. Vincent and the Grenadines adjust to external resource constraints in an orderly and efficient manner. Orderly adjustment was required if the structural impediments to improving growth rates were to be eliminated and if employment levels were to be increased. The importance of the process for the socioeconomic transformation of St. Vincent and the Grenadines, as well as the country's capacity to insulate itself from frequent external shocks, could not be overemphasized.

The concessional financing for the investment program would serve to maintain the country's debt servicing costs at the low level of 3-4 percent of exports of goods and services, Mr. Hospedales observed. In that context, the recent decision of the World Bank to permit St. Vincent and the Grenadines to retain its IDA status for a limited transitional period, despite the fact that its per capita income level was above the IDA operational cutoff limit, was a welcomed development and reflected the Bank's flexible application of IDA eligibility criteria in the light of its improved understanding of the problems of small island economies. He was hopeful that St. Vincent and the Grenadines and all other small island economies would, in light of the Bank's decision on IDA, soon become eligible for Special Disbursement Account resources from the Fund.

Notwithstanding the assured flows of concessional financing and the significant savings being generated by the public sector--6.6 percent of GDP in 1985--the Government's intention to strengthen fiscal and balance of payments adjustment efforts was well conceived, Mr. Hospedales remarked. Recently introduced revenue raising plans and expenditure restraining measures were well placed in that regard. Through an improvement in the efficiency of tax administration and collection procedures, and the introduction of some minor tax measures, revenue performance would be strengthened and should offset the small slippage that had occurred in 1985. On the expenditure side, wage increases in the current fiscal year were being postponed, thus effecting a more realistic structure of public sector wages and helping to improve the international competitiveness of the economy. In addition, government subsidies were being reduced, the monitoring of expenditure control was being enhanced, and current transfers to state enterprises were being cut back through better management structures and more realistic pricing policies, including increases in port, water, and electricity charges. Also, sugar operations--which had represented a substantial drain on the Government--had been closed, although the staff might wish to comment on the employment consequences of that closure. Finally, while he had been heartened to learn from the staff report that St. Vincent and the Grenadines had been pursuing a well conceived program of adjustment and that fiscal targets were realistic and achievable, he was deeply concerned with the alarming unemployment figures; and he would welcome staff comment on the prospects for the long-term growth rate for St. Vincent and the Grenadines and the likelihood of that growth rate absorbing the high level of unemployed resources.

Mr. Foot endorsed the staff's view that the authorities of St. Vincent and the Grenadines had made considerable progress since the previous Article IV consultation discussion. Like Mr. Hospedales, he found the level of unemployment unacceptable for the longer run, and its reduction must be the focus of the authorities' policy efforts in the years to come.

As he had remarked in other discussions of countries tied to the Eastern Caribbean dollar, he wondered whether the exchange rate policy being followed was necessarily appropriate, Mr. Foot continued. It was to be hoped that the deliberations on that issue by the East Caribbean Central Bank would soon bear fruit; and it would be interesting for the Board to review the results of those deliberations in a general discussion, separate from their implications for individual countries in the course of Article IV consultation discussions.

He agreed with the staff that the level of pay increases to the sizable civil service in St. Vincent and the Grenadines and to the public sector more generally, should be monitored and the restraint should be exercised so long as the principle of restraint was not used as an argument against the need to pay key civil servants a fully adequate wage, Mr. Foot commented. Finally, he cautioned the authorities against going ahead with the tax concessions described on page 9 of the staff report without giving further thought to their implications. As he understood it, tax concessions at present were aimed, inter alia, at encouraging mortgage lending, and consideration was being given to extending those concessions to certain other desirable productive activities. Experience in the United Kingdom showed that such a course of action tended inevitably to distort price signals in the economy and that it was virtually impossible even in a relatively simple system to prevent the supposed benefits to the desired areas from leaking into other areas. Hence, while he could fully understand the rationale behind the proposal, he hoped the authorities would give it more thought. Once such concessions were in place, they could become expensive and politically difficult to reverse.

Mrs. Walker observed that the authorities of St. Vincent and the Grenadines had taken steps in a number of key areas to reverse the fiscal imbalances evident in 1983/84 and to improve the position of the state enterprises. Furthermore, their efforts to improve the liquidity position of the National Commercial Bank and to introduce more flexibility in the interest rate structure were welcome. While the real growth rate of the economy had been only 3 percent in 1985, prospects for sustained growth in future were good, particularly if the Government's efforts in the fiscal area were maintained according to the intention of the authorities.

Future prospects for the economy rested on the achievement of the Government's development strategy, Mrs. Walker considered. In that regard, she welcomed the indication of the Government that "the private sector should play the major role in the development process," and that the role of the public sector was to provide the necessary infrastructure to encourage private sector activities. She was pleased to note that the World Bank felt that the revised public sector investment plan was consistent with the Government's development strategy and that development would occur in areas where financing was available and implementation of projects was most feasible.

The promotion of nontraditional export sectors of the economy should be encouraged in order to secure sustained growth and increased employment, Mrs. Walker continued. She welcomed the Government's efforts to encourage private sector participation in building tourism and nontraditional export industries. The development of infrastructure to support those efforts, particularly in the areas of water and electricity, were warranted; the development of port and airport facilities--with private sector assistance--should also be a matter of priority. Clearly, efforts to promote labor-intensive industries were needed to increase employment.

The favorable outturn of the central government finances and the strengthening of the financial position of the state enterprises had taken a strong effort by the authorities, Mrs. Walker commented. The turnaround in the financial position of the public sector enterprises had been particularly noteworthy, since their finances had been generally weak during the past five years. While the outlook for the fiscal position remained favorable for 1985/86, the authorities should maintain a cautious wage policy geared toward restructuring the civil service in a way that would enhance managerial capacity. She welcomed the measures to liberalize the interest rate structure, as well as the move toward the gradual elimination of the tax on interest-earning bank deposits. Finally, she agreed with Mr. Foot that it would be interesting to hear the results of the study currently being conducted by the East Caribbean Central Bank on the exchange rate of the Eastern Caribbean dollar.

The staff representative from the Western Hemisphere Department observed that the unemployment problem in St. Vincent and the Grenadines had been among the main issues discussed with the authorities during the consultation. Their concern had made the unemployment problem a priority issue that must be resolved to set the stage for a recovery of the economy. Toward that end, the authorities were putting in place the infrastructure that would support the development of the private sector, which it was hoped would establish labor-intensive industries that would help to alleviate the unemployment problem. Even though the public sector investment program would increase significantly in the next few years, the structural investment contemplated would not in itself create much employment; the employment effect would be felt when the infrastructure built by that investment bore fruit and when water and electricity, for example, were provided to the free zones and appropriate industries were established.

A similar effect would be seen in the area of agriculture, the staff representative continued. The authorities were attempting to stimulate the development of winter vegetable programs and other types of crops to take up some of the labor that had been displaced from the sugar industry. It should perhaps be noted that while the authorities were certainly concerned about employment, they had been cautious not to attempt to solve the problem by increasing public sector employment. They were well aware of the experiences in other countries in the region and preferred their own approach to dealing with the unemployment problem rather than using the public sector as an employer of last resort.

The East Caribbean Central Bank had recently completed the reviews on exchange rate policies conducted for each of the individual countries in the area, and the Board of Directors of the Bank had had an opportunity to consider the recommendations, the staff representative noted. As he understood it, the indications were that some countries would benefit from an exchange rate action, while others would not. As had been mentioned on other occasions, unanimous agreement among the members was needed before any exchange rate action could be taken, and it appeared that such agreement would not be reached. Hence, the recommendation of the Board of Directors of the East Caribbean Central Bank was to take no action at present. Instead, it had suggested that member countries attempt to harmonize their exchange rate systems and eliminate any taxes that would affect foreign exchange transactions.

On Mr. Foot's concern with the extension of tax concessions described on page 9 of the staff report, the staff representative noted that interest-bearing bank deposits were subject to a 2 percent tax payable by the banks, but that, recently, the authorities had permitted the banks to reduce the base for the computation of the tax by the amount of lending for certain purposes. The intention was to eliminate the 2 percent tax itself by 1987 but to do so gradually--so as to avoid a direct impact on the public revenues--by allowing deductions from the deposit base against the tax.

The Deputy Director of the Exchange and Trade Relations Department recalled that Mr. Hospedales had made a reference to the possible use by St. Vincent and the Grenadines of resources from the Special Disbursement Account. Within the next 10 days, the Executive Board would be discussing more generally the criteria for eligibility for use of resources of the Special Disbursement Account on the basis of a staff paper, EBS/85/283 (12/17/85). St. Vincent and the Grenadines was not among the 55 countries mentioned in that paper as candidates for such resources because it had not been among those receiving funds from IDA. Since the paper had been circulated, however, the World Bank had indicated that St. Vincent and the Grenadines and some other countries in the same area would receive concessional assistance on a temporary basis through IDA. The staff would take the position, as outlined in EBS/85/283, that the Executive Board would probably need to retain the authority to amend the initial list of 55 countries and that the Board's position should be taken independent of any action adopted by the World Bank.

Mr. Leonard observed that some of his colleagues apparently did not share his enthusiasm for what had been accomplished in St. Vincent and the Grenadines over the past 18 months. As he saw it, an extraordinary turnaround, amounting to nearly 5 percent of GDP, had been effected in one fiscal year in the current balance of the Central Government's budget. A turnaround had also been witnessed in the finances of the parastatals. Unfortunately, the improvement had been registered entirely on the financial side and, as various Directors had noted, it was important for the authorities to begin to tackle the underlying economic problems, which were clearly manifested in the 35-45 percent rate of unemployment. The unemployment problem reflected the phasing out of some activities and the need to expand the productive base of the economy. The authorities were cognizant of the need to encourage growth and provide more job opportunities; they had a clear idea of the broad pattern of development that the economy should follow and of what priorities should be observed. However, their financial resources and administrative capacity were perhaps not sufficient to meet those problems, and help from donors would continue to be necessary. In pleading for continued donor assistance, Mr. Hospedales had suggested that St. Vincent and the Grenadines should perhaps be eligible for resources from the Special Disbursement Account, a point he hoped his colleagues would bear in mind when the disbursement arrangements of that Account were considered by the Board in greater detail.

The countries in the Caribbean region were attempting to prepare themselves for the time when IDA assistance would no longer be available, Mr. Leonard continued. As some Directors were aware, the authorities were seeking to establish a special facility for the islands, under which the member states would work systematically with donors, the Fund, and the World Bank to attack structural problems in the region and encourage self-sustaining development. Many aspects of the proposal had yet to be worked out, and it would assuredly be premature to predict its success; however, it represented a commendable initiative by the islands and was certainly deserving of the sympathetic hearing that it had been receiving from all those concerned.

On the matter of tax concessions to the banking system, Mr. Leonard observed that the authorities were taking a cautious attitude; nevertheless, they saw the existence of the tax and the potential for giving relief from it as a means of inducing the banks to provide more lending for productive purposes. The authorities were anxious that the banks should do more in the way of financing investment and believed that the use of offsets against the tax base could provide them with the necessary lever to achieve their aims. However, they had an open mind on the issue and would give serious consideration to Mr. Foot's views.

The Acting Chairman made the following summing up:

Directors were in general agreement with the appraisal in the staff report for the 1985 Article IV consultation with St. Vincent and the Grenadines.

Directors welcomed both the commitment of the authorities to economic adjustment and the substantial progress that had been made in strengthening the public sector finances. They noted the sharp improvement in central government operations in FY 1984/85 and in the current fiscal year and commended the authorities for their firm commitment to containing expenditure, including that on wages and salaries. Directors remarked on the strengthening of the financial position of public enterprises and drew attention to the decision of the authorities to discontinue domestic production of sugar and to adjust public sector prices. The resulting improvement in public sector saving would be particularly important in supporting the increase foreseen in the public sector investment program in the next few years. Directors recognized the need to strengthen the civil service, particularly to facilitate the implementation and monitoring of the public sector investment program; and felt that, while the growth of public sector pay overall should be contained, that principle should not be taken as an argument against the need to pay key civil servants a fully adequate wage.

Directors noted the serious structural weaknesses in the supply base of the St. Vincent and the Grenadines economy and expressed support for the Government's policy of promoting private sector participation in the development of labor intensive industries and in export-oriented manufacturing and tourism, especially in view of the high rate of unemployment prevailing in the country, which was a matter of great concern. In that connection, an increased role for the World Bank was encouraged. The islands, it was noted, would need to rely on considerable inflows of concessional finance to supplement domestic savings for the financing of productive investment projects.

Directors welcomed the authorities' recent decision to remove the ceiling on interest rates and to reduce the effective tax rate on bank deposits. While consideration was being given to removing the tax altogether, it was noted that thought was also being given to ways of reducing the base of deposits on which the tax was levied, perhaps by allowing deductions for the amount of bank lending for investment purposes. The authorities were urged to be cautious in employing such an approach, which experience elsewhere showed might lead to lending that did little to promote capital formation. Also, in light of the questions about the adequacy of the exchange rate, Directors expressed interest in the status of collaborations with the East Caribbean Central Bank and of its review of the appropriateness of the external value of the Eastern Caribbean dollar. It was noted that the maintenance of cost competitiveness, in the absence of exchange rate action, would require the continuation of tight domestic demand policies, including cautious public sector pay policies.

It is recommended that the next Article IV consultation with St. Vincent and the Grenadines be conducted on an 18-month cycle.

2. QATAR - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Qatar (SM/85/342, 12/30/85; and Cor. 1, 1/13/86). They also had before them a report on recent economic developments in Qatar (SM/86/12, 1/17/86).

Mr. Finaish made the following statement:

Prior to the unfavorable developments in the oil sector in 1985, Qatar had made substantial progress in its efforts to adjust to the changed economic environment since mid-1981. These adjustment efforts were undertaken within the overall framework of the country's long-term strategy of diversifying growth through a broadening of the productive base. This strategy had been successful in laying the basic infrastructural network, which made it possible to significantly reduce the development outlays after the weakening in the oil market without seriously disrupting the growth process. It also helped maintain high growth rates of the non-oil GDP up to 1982 with relative financial stability. However, the fiscal restraint imposed by the falling oil receipts considerably slowed down activity in the non-oil segment of the economy in 1983 and 1984. Nevertheless, it is significant that the impact of financial constraints was largely confined to construction and service sectors, whereas the production sectors have generally been growing in this period.

Oil plays a pivotal role in Qatar's economy, and the revenues generated by it have determined the overall growth performance of the economy as well as the pace of activity in the non-oil sectors. Having peaked in 1973 at 570,000 barrels a day (b/d), output of oil fell by almost half over the subsequent ten years to 294,000 b/d in 1983. Though there was a pickup in the production as well as export of oil in 1984, they again fell sharply in the subsequent year. As a result, oil export earnings were almost halved over the four year period 1981-85. The continued fiscal austerity led to a 3 percent decrease in non-oil GDP in 1984, in current prices, but owing to the substantially improved performance of the oil sector during the year, the overall GDP recorded a 10 percent growth over the depressed 1983 level.

No major oil discoveries have been made in the recent past. Last year, the Government signed a 25-year production sharing agreement with an international oil firm and has also received bids for new concession areas. Simultaneously, consistent efforts have been made to broaden the hydrocarbon sector by tapping the large deposits of natural gas. The two refineries and petrochemical and fertilizer plants were set up with the same objective in view. As a result, the available associated and nonassociated gas is already being largely utilized and arrangements are underway to harness the North Dome Gas Field, which is reported to be the world's largest. The first phase of the project is due for completion by the late 1980s at a cost of $1 billion and will meet the country's requirements for gas. Its completion has become necessary for the operation of existing utilities and industries at full capacity in view of the reduced availability of associated gas and fast depletion of the reserves of nonassociated gas. The second phase of the project involving a cost of $6 billion to produce liquefied natural gas (LNG), if found feasible and implemented, will greatly diversify the economy's base, especially in the hydrocarbon sector.

Despite the constraints posed by the lack of other natural resources and a small domestic market, the non-oil industrial sector has also expanded steadily over the years, and the Government is offering a comprehensive package of financial and other incentives and technical assistance to the private sector to encourage the setting up of small and medium industries. Similarly, though agricultural, fishing, and other related activities face many unfavorable natural factors, they have also received substantial encouragement from the Government, and, consequently, an increasing proportion of domestic requirements for various agricultural and like products is now being supplied locally.

The fiscal operations of the Government, which are mainly determined by developments in the oil market, have been under constant review by the authorities. Despite the increase in revenues from oil and gas during 1984/85, the continued austere fiscal stance led to a further 3 percent decline in total expenditures, resulting in a significant budget surplus. The financial strategy adopted also included an increase in import duties and the discontinuation of the subsidy on meat. This followed the 30 percent average increase in domestic prices of petroleum products effected in 1983. The authorities remain cognizant of the need to enhance domestic non-oil revenue receipts and to further restrain the growth of recurrent outlays. Some additional measures on these lines, like the imposition of user fees in education and health sectors, are under consideration while others will be implemented in coordination with other members of the Gulf Cooperation Council to strengthen the fiscal and external balance. During the current year, the budgetary outcome is projected to be a deficit owing to an estimated 31 percent shortfall in the oil and gas income, despite some improvement in non-oil revenues and reduced current outlays. Notwithstanding this stringency, the authorities intend to continue their external assistance program, though at a lower level.

In 1983, the steep fall in net foreign assets of the banking system and reduced lending to the private sector owing to slackened activity in construction, trade, etc., led to a net marginal contraction in domestic liquidity. In 1984, though net foreign assets rose substantially, a sharp decrease in outstanding credit to private sector moderated the expansionary impact the buildup of these assets, allowing growth of liquidity by 22 percent over the year. Last year, the monetary expansion was estimated at 5 percent mainly due to some recovery in credit to the private sector. The relatively slow liquidity expansion in the recent past has helped contain the inflation rate to an annual average of about 3 percent during 1982/84.

In the wake of the slowdown in economic activity, the authorities have lately taken several measures to monitor and improve the quality of commercial banks' portfolio of domestic assets. Some cases of debt repayment problems that had arisen, were resolved satisfactorily, and the Qatar Monetary Agency asked some banks to increase their provisions for doubtful loans.

The authorities continue to be vigilant about any adverse effects on loans and deposits in domestic currency of the ceilings on interest rates, and an inter-agency committee is examining appropriate remedial measures, including the introduction of differentiated reserve requirements for foreign and local currency deposits.

After experiencing deficits in 1982 and 1983, Qatar's balance of payments achieved a surplus in 1984 due to increased export receipts from oil as well as other items and a further drop of 20 percent in imports, though foreign grants and loans showed a small increase over the year. The situation again deteriorated last year mainly due to an estimated sharp decline of 23 percent in receipts from oil exports. Consequently, a net deficit in the balance of payments again emerged, though lower than in 1982 and 1983. The small increase in imports recorded in 1985 over the low level of the previous year was for building up stocks.

Along with the adaptation of policies dictated by financial prudence, Qatar has maintained a liberal trade and exchange system. Though its reserves of foreign assets provide a cushion for sustaining the growth momentum of the economy for some time in the face of reduced oil receipts, authorities are alive to the imperatives of developments in the oil market and intend to take appropriate adjustment measures whenever necessary.

Mr. Suraisry observed that the economy of Qatar had been adversely affected by recent developments in the oil market. Since the previous Article IV consultation discussion (EBM/83/172, 12/14/83), Qatar's oil revenues had declined further, and a fiscal deficit was projected to emerge for 1985-86. The authorities' response to the projection had been a prudent one. They had avoided sharp reductions in government expenditures which could have unduly weakened the economy and had adopted a course of action involving a combination of a reduction in spending and some financing from reserves. Hence, the sharp reduction in revenues had been accompanied by a gradual decline in outlays. Initially, the decrease in expenditures had been facilitated by the completion of major infrastructural projects. However, the authorities had also reduced current outlays: wages and salaries had been frozen for four years; efforts to reduce the size of the civil service were under way; and some subsidies had been eliminated. In addition, the authorities were continuing to explore ways of raising non-oil revenues and reducing expenditures. Implementation of such revenue-raising measures, which were currently under discussion by the Cooperation Council for the Arab States of the Gulf (GCC), might become urgent, in view of the recent developments in the international oil markets. He understood from Mr. Finaish in that regard that the authorities had apparently already implemented some of those measures.

The authorities in Qatar had continued to emphasize the role of the private sector and diversification of the productive base of the economy, Mr. Suraisry observed. They had come a long way in developing the hydrocarbon sector, which had been expanded with the establishment of refineries and petrochemical plants. The North Dome Gas Field, when finished, should carry that process even further. The authorities had also pursued policies oriented toward increasing the contribution of the manufacturing sector to GDP. The establishment of several industries--such as cement, steel, and iron--had been a good step in that direction. While the development of the manufacturing sector was not an easy matter in a country like Qatar, the authorities were making every effort to make the sector less dependent on oil and to alleviate the impact of adverse developments in the oil market. Those efforts should be facilitated by the work being done by GCC members to link their economies and integrate their markets so as to create an environment that was conducive to economic diversification and private sector promotion. Progress toward those ends was naturally slow; nevertheless, the GCC member countries were determined to continue their efforts.

On the monetary side, the authorities in Qatar faced new challenges as a result of the recent slowdown in economic activity, Mr. Suraisry commented. They were aware of the problems stemming from capital outflows and the nonpayment of some commercial bank loans, and the measures they had adopted to address those problems were welcome. He agreed that there was perhaps an urgent need to require the commercial banks to make adequate provision for bad debt, and he noted from Mr. Finaish's statement that the monetary authorities had already instructed the banks to make such provision.

Qatar appeared to be following sound external policies both in the management of international reserves and in the approach to the exchange rate, Mr. Suraisry said. He agreed with the authorities and the staff that there was no need to change the current exchange rate policy. On a related matter, the authorities should be commended for the maintenance of an aid program despite the difficult economic and financial conditions facing the economy. Their willingness to continue following prudent policies to adjust the economy to the decline in oil revenues and to diversify the productive base was commendable.

Mrs. Walker observed that the authorities in Qatar had responded well to the decline in oil exports and oil prices over the past several years. Efforts to implement fiscal restraint in the face of declining oil receipts and to develop other areas of the economy--notably the initiation of the North Dome Field gas project--had aided economic adjustment in the face of changes in the oil market. Unfortunately, the medium-term outlook was clouded by the uncertainty surrounding future oil prices, an uncertainty that signaled the need to continue the pursuit of prudent policies in the fiscal and monetary areas. The staff estimates for the medium-term outlook had regrettably been complicated by the lack of adequate data on developments in the oil sector and in the balance of payments since 1984; however, they indicated that the overall balance would be in deficit for the next two years, reflecting the impact on the balance of payments position of current budgetary trends. While the level of foreign assets was adequate to provide a cushion if those trends continued, it would clearly be prudent for the authorities to take precautions in their fiscal policy and exercise even more restraint than might otherwise appear necessary at the present stage. In that light, she welcomed the assurances given by Mr. Finaish that the authorities were aware of the need to enhance non-oil revenue and further restrain the growth of current outlays.

According to the staff, the "subsidies implicit in the provision of a number of government services are considerable," Mrs. Walker continued. Furthermore, electricity and water were supplied free in most cases. Those subsidies could be a drain on government finances, and she therefore welcomed the consideration being given by the authorities to the imposition of some user fees in certain sectors. She also urged the authorities to consider, during their review of pricing policies, the elimination of implicit subsidies on gas and petroleum products, the possibility of implementing a more flexible pricing policy for cement and poultry products, and an increase in import duty rates, which had remained low compared with rates in other members of the GCC.

Expansion in the non-oil sector of the economy would provide a cushion against adverse developments in the oil sector, Mrs. Walker considered. Hence, she welcomed the Government's attempt to encourage private sector involvement in the establishment of small- and medium-size industries. Also welcome were the recent efforts of the authorities to monitor and improve the quality of commercial banks' domestic assets. She agreed with the staff that further strengthening of the monetary authorities' supervisory procedures and provisioning for bad debts by commercial banks would be prudent. Finally, Mr. Finaish's assurances that the authorities intended to take appropriate adjustment measures whenever necessary were welcome. In light of the weakening of the balance of payments position and the volatility of the oil market, a flexible response by the authorities of Qatar, together with prudent fiscal policies, should help to maintain growth in the face of whatever developments might occur in the oil market.

Mr. Mawakani noted that Qatar had apparently adjusted to lower oil revenues without any major disruption in domestic economic activity. The authorities should be commended for following prudent financial policies, which had contributed to a lowering of inflation and the maintenance of an open economy. The medium-term development strategy aimed at reducing the country's dependence on oil production and exports was appropriate, and its successful implementation should help to establish a foundation for continued and self-sustaining economic growth. However, the authorities should avoid the temptation to be overprotective of newly created industries through the use of subsidies and tariffs. Such an approach could lead to an inefficient allocation of resources, which in the long run might be harmful to the economy. The development of capital-intensive industries where the country held a comparative advantage might be considered; but other sectors where the potential for economic development and growth existed should not be neglected.

The authorities were rightly following a policy of restraint in government spending, which had been effective in containing the overall fiscal deficit, Mr. Mawakani continued. It was encouraging to note that the authorities were conscious of the need to maintain that stance and had decided to scale down spending plans for 1985-86. Such measures as a reduction in subsidies and transfer payments would help to alleviate pressure on the public finances. A user fee for public utilities would also facilitate the effort to reduce waste and improve the revenue position of the Government.

The slowdown of the economy of Qatar, the proximity of offshore banks in Bahrain, and the interest rate policy being followed by the monetary authorities seemed to be having an adverse impact on the domestic assets portfolio of the commercial banks, Mr. Mawakani commented. He agreed with the staff that it was important to strengthen the supervisory role of the Qatar Monetary Agency and to provide it with the necessary tools to deal effectively with the problems confronting the banking sector. Finally, the authorities should be commended for continuing to provide significant amounts of foreign aid, in spite of the weakening of the oil revenues of the country.

Mr. Salehkhou observed that oil exports were the major source of government revenues and heavily influenced economic activity in Qatar. During the past decade, the Government's attention had been oriented toward major infrastructural projects; however, with the downturn in oil revenues during the past two years and the consequent sharp reduction in government expenditures, economic activity had slowed as part of an overall strategy aimed at adjusting economic policy--through fiscal restraint--to the changing circumstances of the world economy, and more particularly, to the decline in oil prices and consumption that had necessitated production cuts to nearly 294,000 barrels a day as against the potential of 570,000 barrels a day. At the same time, the authorities had been endeavoring to broaden the base of the economy through diversification as a longer-term objective.

On the occasion of the previous Article IV consultation discussion, the Executive Board had commended the Qatar authorities for pursuing appropriate fiscal and monetary policies while maintaining a liberal trade and exchange system in the face of monetary difficulties resulting from the sharp decline in oil revenues, Mr. Salehkhou recalled. At present, the authorities seemed to be pursuing with the same determination the adjustment policy begun in 1983, albeit with greater difficulty because of the uncertainties in the oil sector. Given the limitations in oil reserves at present and the fact that no new fields had been discovered, the authorities' long-term strategy was to develop the gas industry for domestic use and exports. The expected production of liquefied natural gas from the North Dome Field along with the linkage project of gas distribution with neighboring states should boost Qatar's earnings by the 1990s, thus supporting the resources derived from the oil sector.

The drive toward diversification away from dependence on the oil export sector had led to the creation of a number of small industries, such as cement, fertilizer, and food processing, Mr. Salehkhou noted. However, the oil sector remained the primary source of government revenue. Indeed with the decrease in government spending since 1983, non-oil GDP had registered a decline of 3 percent in 1984. Reduced government spending had also had an impact on employment, as large government contracts in the construction sector had not been renewed, and some 15,000 foreign workers had been repatriated between 1983 and 1984.

The public sector, which employed 60 percent of the work force, had imposed a freeze on salaries for the past four years, Mr. Salehkhou observed. That freeze, together with the sizable reduction in government spending and lower prices abroad, had had a moderating influence on the cost of living index, which had increased by only 3 percent and 1 percent in 1983 and 1984, respectively.

Qatar's fiscal policy reflected the evolution in the international oil markets, Mr. Salehkhou said. In 1984-85, higher oil exports and lower government outlays had resulted in a slight improvement in the overall fiscal position, which had fallen sharply in the previous year. The 1985/86 budget foresaw a slight increase in expenditures despite lower oil prices, although expenditures would still be below the level recorded in 1984/85. A budget deficit equivalent to 8.6 percent of GDP was anticipated; however, the authorities remained committed to a policy of restraint in public spending, particularly in view of the uncertainties in the oil market. In order to raise revenues, they were studying measures to raise fees on public health services and to adjust tariffs to a level compatible with those in other GCC member countries.

The Qatar Monetary Authority had reinforced its control over the banking system and had sought to limit domestic credit expansion in line with the slowdown in the economy in 1983 and 1984, Mr. Salehkhou continued. However, while net foreign assets remained unchanged in 1985, credit expansion to the private sector had been increased to service an increase in imports. The monetary authorities in Qatar were aware of the fact that the slowdown in economic activity called for a greater monitoring of the quality of assets held by domestic banks, especially those engaged mainly in lending to the construction sector. The establishment of a central risk department should help commercial banks with credit information on existing and potential customers.

As major infrastructural projects had come on stream in the early 1980s, Qatar seemed to have adapted without great strain to the substantial reduction in its oil earnings, Mr. Salehkhou remarked. With uncertainties in the oil market, however, capital projects remained under scrutiny, and a close look had been given to the containment of the budget deficit, a monitoring that had had a favorable impact on the balance of payments, particularly with respect to imports. With the rise in exports in 1984, the trade surplus had been absorbed by the deficit in current transfers, mainly owing to departing foreign workers. Nonetheless, the balance of payments had registered a surplus of $429 million in 1984 against a deficit of $595 million in 1983. Net foreign assets continued to be managed safely and were estimated at the equivalent of 51 months of imports at the 1984 level. Finally, the authorities should be commended for having maintained a significant foreign assistance program, despite the difficult oil situation.

Mr. de Forges stated that he had little to add to the staff appraisal, which had properly commended the authorities in Qatar for their skillful management of the economy and for their pursuit of a generous aid policy, despite falling revenues. It would be helpful, however, if the staff could provide a paper--perhaps in conjunction with the World Economic Outlook exercise--on the implications for the world economy of the current "oil shock." Since November 1985, the price of crude oil had dropped by nearly half to approximately $15 per barrel. Yet, the effects of such a sharp drop--on both developing and developed countries--remained to be assessed.

Mr. Romuáldez commended the authorities for their flexible implementation of economic policies and for having maintained a generous foreign aid program despite the decline in oil revenues.

The Deputy Director of the Research Department, responding to a query by Mr. de Forges, observed that the papers for the World Economic Outlook discussion were nearly complete and were due to be circulated toward the end of the month. The staff had attempted to take into account in those papers recent developments in the oil market and would be making projections on the basis of an assumed oil price that was considerably lower than that prevailing during the previous World Economic Outlook exercise. Of course, it was not possible to follow on a daily basis the turns of the oil market and to change the numbers accordingly. The approach it was intended to follow was based on an assumed price for oil that seemed within the broad range of reasonable estimates and then called for an analysis of the effects of possible changes in that assumption on the projections for individual countries and groups of countries.

As in the past, a separate paper assessing recent oil market trends and prospective developments would be circulated, the Deputy Director continued. The paper would provide in addition some analysis of the implications of different developments in the oil market and should provide Directors with a basis for making an appraisal of how the present level of oil prices affected economic prospects in the world economy. It should also help Directors to reach tentative judgments about how changes in the oil price could affect the World Economic Outlook projections.

Mr. Finaish observed that his authorities in Qatar intended to continue to follow cautious fiscal and monetary policies. The fall in oil prices had important implications not only for oil producers but also for consumers and debtor countries, and he was happy to hear that the implications of recent changes in oil prices would be analyzed as part of the World Economic Outlook exercise.

The Acting Chairman made the following summing up:

Executive Directors were in general agreement with the staff appraisal for the 1985 Article IV consultation with Qatar. They noted that the Qatari authorities had followed appropriate policies in adjusting to the sharp reduction in oil export earnings since 1981, and they commended the authorities for following a prudent fiscal policy, which was reflected in a reduction in expenditures and the containment of the overall fiscal deficit. Also, restrained financial policies have contributed to a low rate of increase of domestic prices.

Directors observed that the initial spending plans for 1985/86 which projected notable increases in current and capital spending were scaled down substantially in view of the prospects for lower oil receipts and an overall balance of payments deficit. In view of the substantial holdings of foreign assets, relatively small budget deficits would be tolerable, but Directors stressed the need to strengthen government finances in the medium term through the adoption of measures to raise domestic non-oil revenue and to contain current spending. In that respect, the authorities were encouraged to examine ways of reducing the currently high degree of subsidization.

Directors noted the considerable efforts being made by the authorities to diversify Qatar's economic base, broaden the hydrocarbon sector, encourage the development of the private sector, and--in the context of the Cooperation Council for the Arab States of the Gulf (GCC)--to promote regional economic integration.

Directors noted the authorities' awareness that the slow-down in economic activity in recent years might have affected the ability of some borrowers to repay loans to commercial banks. They emphasized the importance of strengthening the Qatar Monetary Agency's supervisory role in order to deal effectively with any problems that may arise in this connection.

Directors observed with satisfaction that Qatar was pursuing appropriate external sector policies, that it was maintaining a liberal trade and exchange system, and that it had continued its generous foreign aid program despite lower oil revenues.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/20 (2/3/86) and EBM/86/21 (2/5/86).

3. CANADA - TECHNICAL ASSISTANCE

In response to a request from the Canadian authorities for advice on tax reform proposals currently under consideration, the Executive Board approves the proposal set forth in EBD/86/30 (1/30/86).

Adopted February 4, 1986

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 85/51, 85/53, and 85/54 are approved. (EBD/86/26, 1/28/86)

Adopted February 3, 1986

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/28 (1/31/86) and EBAP/86/29 (2/3/86) and by an Advisor to Executive Director as set forth in EBAP/86/29 (2/3/86) is approved.

APPROVED: September 29, 1986

LEO VAN HOUTVEN
Secretary