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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/47

10:00 a.m., March 19, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. R. Ismael, Temporary
C. H. Dallara	M. Lundsager, Temporary
	G. Ercel, Temporary
M. Finaish	T. Alhaimus
	M. Sugita
	B. Goos
	Jiang H.
J. E. Ismael	
	J. Hospedales, Temporary
	M. Foot
	H. Fugmann
	G. W. K. Pickering, Temporary
	A. Abdallah
	M. A. Weitz, Temporary
	J. E. Suraisry
	S. Geadah, Temporary
P. Pérez	
H. Ploix	
J. J. Polak	
	A. V. Romuâldez
G. Salehkhou	O. Kabbaj
	A. S. Jayawardena
	L. Tornetta, Temporary

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

Asian Department: Tun Thin, Director; N. N. Choudhry, I. Otani, H. Shibuya. Exchange and Trade Relations Department: E. H. Brau. External Relations Department: M. Goldstein. Fiscal Affairs Department: K.-Y. Chu. Legal Department: J. G. Evans, Jr., Deputy General Counsel; P. L. Francotte. Middle Eastern Department: F. Drees. Research Department: H. C. Kim. Treasurer's Department: T. Leddy, Deputy Treasurer, D. Williams, Deputy Treasurer; D. Berthet, J. E. Blalock, D. Gupta, Y. S. Lim, A. F. Moustapha, T. M. Tran. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: S.-R. Bengs, M. B. Chatah, G. Nguyen, M. Z. M. Qureshi, A. Vasudevan. Assistants to Executive Directors: M. Arif, F. Di Mauro, R. Fox, O. Isleifsson, J. M. Jones, H. Kobayashi, J. E. Rodríguez.

1. DESIGNATION PLAN AND OPERATIONAL BUDGET FOR MARCH-MAY, 1986

The Executive Directors considered the designation plan (EBS/86/49, 3/4/86; and Sup. 1, 3/18/86) and the operational budget (EBS/86/50, 3/4/86; and Cor. 1, 3/5/86) for the quarterly period March-May 1986.

The staff representative from the Treasurer's Department noted that actual use of currencies and SDRs under the operational budget for the quarterly period December 1985-February 1986 had been very similar to that shown in Table 3 of EBS/86/50. An updated table was being issued (EBS/86/50, Sup. 1, 3/19/86). On the designation plan, the relatively small changes in the actual and pending use of SDRs as of March 18, 1986 were shown in the supplement to EBS/86/49.

Mrs. Ploix said that she could go along with the draft decision on the operational budget. She confirmed that her authorities agreed in principle with the proposed temporary modification of the traditional method of allocating currencies, as was described in paragraphs 5a and 5b(i) of EBS/86/50, through the September-November 1986 quarter.

She had some presentational questions on the designation plan that she would discuss bilaterally with the staff, Mrs. Ploix stated. She supported the proposed decision on the plan.

Mr. Tornetta observed that the stated objective of the proposal to modify the way in which the blend of currencies used on the receipt side of the operational budget was determined, was to reduce the dispersion in the ratios of members' reserve tranche positions to their gold and foreign exchange holdings. However, while the proposed modification helped to reach that objective, the meaning and the desirability of reducing the dispersion between the ratios of reserve tranche positions to reserves was not clear. Therefore, the economic significance of that ratio should be examined.

The changing balance of payments positions of some members was one of the rationales for reducing the dispersion in ratios that was implied on page 4 of EBS/86/50, Mr. Tornetta noted. However, it was possible for two countries with very different balance of payments positions to show a similar ratio while countries with similar balance of payments positions could have different ratios. That condition existed because the ratio for a member at a given moment reflected a number of circumstances. The numerator of the ratio that was given by the reserve tranche position was related to the member's quota, which in turn was only a very rudimentary proxy of the country's economic and financial importance. It was well known that the ratios of actual to calculated quotas differed widely among members, for historical reasons as well as countries' own decisions. The value of the denominator might be distorted by the distribution of reserves between gold and foreign exchange and by the way in which gold was valued. Furthermore, the significance of the level of reserves was not clear since it did not distinguish between gross and net reserves.

Consequently, because reserves could be increased through borrowing, or foreign debt reduced by the use of reserves, the reserve level might not be a good indicator of a country's balance of payments position or of its financial position. For example, it might well be that countries with a stronger financial position would have smaller reserves because they were confident of being able to borrow from the market in case of need, whereas countries that were less creditworthy might want to hold comparatively larger reserves for precautionary reasons.

In sum, Mr. Tornetta said that his chair could accept the principle that the choice and quantity of currencies to be used in operational budgets should better reflect a country's external position. However, the proposed modification would not lead in that direction in a satisfactory way, and his chair could only reluctantly go along with its provisional application for three quarters. Furthermore, if at the end of that period the mechanism had not been improved to better reflect members' payments positions, it would not be acceptable for a further period.

Mr. Dallara remarked that he was prepared to support the proposed operational budget and designation plan.

A number of members had an interest in accelerating reflows of currencies and there was a general interest in reducing the current wide dispersion in the ratios of members' reserve tranche positions to their gold and foreign exchange holdings, Mr. Dallara observed. It was in that context that his authorities were ready to go along with the modified approach outlined in EBS/86/50, on a temporary basis. As Directors might note, the modified method for reflows had not been applied to the United States in the same way as it had to other countries; if it had been, the reflows to the United States would have been of such magnitude as to thwart, in effect, the objectives of the exercise vis-à-vis other members. While he did not wish to quarrel with the exclusion of the United States from that aspect of the operation, he noted that a high share of U.S. reserves was accounted for by its reserve tranche position. The ratio of that position to U.S. foreign exchange and gold holdings was much higher than that of certain countries whose net reflows would be substantially raised as a result of the approach being taken in the operational budget for the forthcoming quarter. At the same time, as the principal reserve currency, the dollar was legitimately viewed in a different light than were the currencies of most other member countries, although there were certain other reserve currencies that should not be viewed as having identical characteristics as those of many of the other currencies included in the operational budget.

In sum, his authorities were prepared to accept the proposed approach on a temporary basis, Mr. Dallara concluded. He assumed that its subsequent application with respect to the United States would remain the same and that the temporary modification would help to reduce some of the existing dispersion of the ratios.

Mr. Goos said that he could support the draft decisions, including the proposed modifications on the receipt side of the operational budget. At the same time, he stressed that his support rested on the understanding that those modifications would be temporary only--namely, restricted to the subsequent three quarters as proposed by the staff.

In general, the existing principles for the allocation of currencies in Fund operations had proved successful, Mr. Goos considered. In particular, the Fund had been provided with the appropriate degree of flexibility needed to protect its liquidity in the process of establishing and executing the operational budget. He felt strongly that the protection of the Fund's liquidity had to remain the overriding principle in any decision to accelerate the harmonization of the relevant ratios.

Mr. Suraisry joined other Directors in supporting the proposed decision and the modification on the transfer side of the operational budget. While that modification might not be the optimal way to overcome the wide differences in the ratios of reserve tranche positions to gold and foreign exchange holdings, like Mr. Dallara, he hoped that it would be a second best solution that would help to alleviate some of the existing problems.

The Executive Directors then took the following decisions:

a. SDR Department - Designation Plan for March-May 1986

The Executive Board approves the designation plan for the quarterly period beginning March 19, 1986, as set out in EBS/86/49 (3/4/86).

Decision No. 8226-(86/47) S, adopted
March 19, 1986

b. Operational Budget for March-May 1986

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/86/50 (3/4/86), page 3, footnote 1 and the operational budget for the quarterly period beginning March 19, 1986, as set out in EBS/86/50.

Decision No. 8227-(86/47), adopted
March 19, 1986

2. MALDIVES - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Maldives, together with a proposed decision concluding the Article XIV consultation (SM/86/27, 2/12/86; and Cor. 1, 3/11/86). They also had before them a report on recent economic developments in Maldives (SM/86/34, 2/24/86).

Mr. Finaish made the following statement:

Contrary to the concerns about its performance in 1985, the Maldivian economy maintained its high growth rate and showed creditable overall improvement, expecially in the latter half of the year. These developments were due equally to the increase in the fish catch and export and tourist activity, on the one hand, and the concerted policy reforms introduced in the external and domestic sectors, on the other. Furthermore, the continued readiness of the authorities to undertake measures necessary for maintaining the economy's growth momentum and strengthening its internal and external balance augurs well for the future prospects of this small open economy comprising a large number of scattered islands.

The improvement in 1985, in fact, was in continuation of the steady progress which the economy had maintained since the early 1980s. The 10 percent growth rate in real GDP in 1985, though lower than the average annual growth rate of 12 percent recorded during the preceding four years, was achieved despite a cut of about 40 percent in development outlays during the year as part of the policy of fiscal restraint. It attested to the strong base for the economy's expansion that has been laid through infrastructural development over the years. The most significant development in the external sector was the introduction on July 1 of an adjustable peg of the rufiyaa to a basket of the currencies of the country's main trading partners that served to correct a considerable part of the previous exchange rate appreciation. Aided by the fiscal discipline maintained during the year that reduced the budgetary deficit to one third of the projected level, this significant policy shift helped the country to achieve a surplus--the first in the 1980s--in the balance of payments. Yet the inflation rate of 5 percent over the year indicated by the GDP deflator, though not very high, nonetheless reflected an increase, partly due to the fact that the fiscal deficit had to be almost entirely financed through domestic bank borrowings. Consumer prices of essential items, however, rose by 1 percent only during the year.

Fisheries and tourism continue to be the mainstay of the economy; they contributed about 37 percent of GDP in 1985. The fisheries sector, which still employs about 45 percent of the total labor force, has fully recovered from the slump of 1982 and the annual catch has since increased by 95 percent. The development projects in this sector that are currently under way will further enlarge capacity through improvement in infrastructural and fish aggregation facilities and additions to mechanized vessels/boats. Tourism activity, which had steadily increased over the years, expanded significantly last year, facilitated by the continued economic recovery in Europe, the depreciated rufiyaa, and an increased number of long-distance scheduled flights. Though there still exists some scope to increase revenues in this sector through greater utilization of the already installed resort capacity, expansion of capacity in areas beyond 15 miles from the airport will be possible only after interisland transportation facilities are developed. As regards international shipping, in the wake of many adverse developments abroad, the process of its reorganization and rationalization through a reduction in the size and the capacity of the fleet and replacement of fuel-inefficient ships is continuing.

In 1985, Maldives was able to continue the policy of fiscal restraint despite the expansionary stance implied by the initial budget estimates. Consequently, the overall deficit recorded a net decline over the year and turned out to be one third of the budgeted amount, despite a reduction of 28 percent in foreign grants. This achievement was made possible by a continued check on expenditures and a 12 percent increase in revenue receipts--higher than budgeted--due to increased tourist activity and the measures taken early in the year and in 1984.

Because of continued resource constraints, the authorities intend to maintain the policy of fiscal prudence and reduce the fiscal deficit in 1986 from the projected Rf 90 million to Rf 50 million. To achieve this, expansion of the revenue base through the imposition of an entertainment tax and tariff reform, including changes in the structure of import duties and the valuation of imports for tax purposes from a freight on board (f.o.b.) to a cost, insurance, and freight (c.i.f.) basis, as well as reduction of exemptions, is being contemplated. The authorities are also contemplating the imposition of an income tax and a charge on drinking water. As regards expenditures, capital outlays, after having risen by 109 percent in 1983, have been declining in pursuance of the official policy of bringing them down to a sustainable level. Presently, only 8 of the 12 foreign-aided projects are under implementation, and a procedural change effected last year is expected to enable the authorities to improve overall control of capital expenditures. The increase in current expenditures is partly accounted for by the maintenance expenses of completed projects in education and other sectors. The number of civil servants has increased over the years, but the authorities have made efforts to contain increases in their wages. Furthermore, the present slack in the labor market in the oil exporting countries and the relatively slower growth of the domestic economy are expected to ease the pressure on wages in Maldives. The authorities also expect the efficiency of civil servants to increase in the period ahead due to the educational programs that are under way.

Although the fiscal deficit was reduced in 1985, it was almost entirely financed domestically due to a 75 percent decline in the disbursements of foreign loans. Combined with the financing needs of public enterprises, it resulted in a considerable expansion of credit to the public sector and of the overall money supply. The credit control measures introduced during the year was aimed, inter alia, at redirecting bank lending from commercial sectors, especially tourism, to production sectors like agriculture. Through these measures, outstanding credit to the private sector was reduced slightly following the large average annual increase of 56 percent recorded during the preceding three years; however, it is expected to increase in 1986 due to the further expected expansion in tourist activity and in private sector exports. The staff proposal for increased reserve requirements would check the overall expansion of credit but would not by itself help promote its desired sectoral allocation. It should also be noted that the authorities have maintained a flexible stance in enforcing the proportions of bank loans earmarked for various sectors. They have also assured the banks that advances for financing exports would be considered outside the credit-deposit guidelines. As regards government borrowing in 1986, due consideration is being given to developing the necessary policy framework to keep it to the minimum.

The year 1985 was marked by significant developments in external transactions and the exchange rate system. Contrary to earlier expectations, the current account deficit declined considerably owing to substantial increases in fish exports and tourist receipts, supplemented by restrained imports and reduced costs of operating the shipping fleet. These developments led to a small overall surplus despite a sharp decline in gross disbursements of external loans in the wake of reduced capital outlays in the country. The substantial decline in garment exports--which had been quite buoyant since 1981 when production began--as a result of reduced demand abroad underlined the continued vulnerability of this small open economy to external developments.

With effect from July 1, 1985, the rufiyaa has been linked to a trade-weighted basket of currencies of the country's major trading partners, succeeding the previous arrangement of pegging to the U.S. dollar. This measure was in accordance with the recommendation made during the last Article IV consultation. Due to the frequent adjustments in the exchange rate made thereafter, the nominal effective exchange rate of the rufiyaa had depreciated by about 11 percent by end-December.

The authorities are appreciative of the basic weakness in their balance of payments and the need for continued decisive policy response to rectify it. Hence, on the payments side, imports are being contained, while a major tariff reform is scheduled to take effect on April 1 of this year. On the receipts side, it is hoped that exports, including garments, and tourism activity would increase considerably in 1986. In this connection, the authorities expect the more flexible exchange rate policy that has been adopted to prove helpful and they will be aiming at a suitable package of policies to accompany the further correction of the exchange rate. At the same time, the authorities are taking steps to further strengthen their external debt management.

Mr. Sugita noted that economic performance in Maldives had improved in 1985. Real GDP had increased by 10 percent, and the current account deficit had declined slightly. The continued expansion of the economy, however, had begun to exert increasing pressure on the labor market, and considerable wage increases for workers in the tourism sector had contributed to a rise in the inflation rate to 5 percent. In that context, and in view of the continuously high fiscal deficit, the tightening of fiscal and monetary policies in 1985 was appropriate. Nevertheless, the 1986 budget again envisaged an expansion of expenditures and an overall deficit of 12 percent of GDP. Although past experience showed that the actual deficit might be substantially lower, a decisive tightening of fiscal policy was imperative.

Considerable weakness persisted in the area of the balance of payments, Mr. Sugita continued. Current account deficits were large and the external debt was high. International reserves, at only one month's imports, were inadequate. The medium-term prospect for the balance of payments was bleak and clouded by an ambitious development strategy and growth targets. External vulnerability and the shortage of skilled labor placed major constraints on medium-term growth prospects, calling for a realistic reassessment of those growth targets.

The authorities were to be commended for the change they had introduced in the exchange rate regime in July 1985, and for the recent exchange rate adjustments, Mr. Sugita said. However, the existence of the parallel market, and the rate prevailing in that market, seemed to indicate the need for further adjustment. He recognized the difficult implications that a further adjustment in the exchange rate might have for the rate of inflation, since the economy was currently at full employment and since there had already been some depreciation of the rufiyaa. But as the staff suggested, the stability of world prices envisaged for 1986 seemed to provide a good opportunity for an exchange rate adjustment. Of course, under present conditions of labor shortage, such an adjustment would have to be accompanied by tight financial policies and wage restraint.

There was an urgent need to rectify the fiscal imbalance, Mr. Sugita observed. On the expenditure side, government employment policy would have to be re-examined in order to arrest the increase in wage bills. The reduction in the growth target, which he had mentioned, should lead to a reassessment of the priorities of investment projects and contribute to the overall restraint of investment expenditures. Control over capital spending would also have to be strengthened. On the revenue side, he endorsed the staff proposal for a broadening of the revenue base and a strengthening of the tax structure, with a view to rectifying the overdependence upon import duties and the tourist tax. According to Mr. Finaish's statement, the authorities were contemplating the introduction of an income tax, which would be most welcome.

A further reduction in the growth of monetary aggregates was essential, and would have to be supported by fiscal restraint, Mr. Sugita concluded. With respect to the instruments for tightening monetary conditions, interest rates and reserve requirements were preferable to the present system of credit rationing, which should be replaced as and when circumstances permitted.

Mr. Geadah observed that the Maldivian economy had performed quite well in the past two years. GDP had grown by about one third, and an overall surplus in the balance of payments had emerged in 1985. The improvement had been due largely to the progress achieved in the fishing and tourism sectors, as well as to the tightened fiscal and monetary stance. In the fishing sector, the sharp increase in output had been spurred by improvements in mechanization and in infrastructure, supported by an adequate price policy. The tourism sector had continued to expand rapidly in response to promotional campaigns. Those were commendable achievements.

Nevertheless, the outlook for the medium term indicated that corrective measures were needed to sustain the growth in output, as demonstrated by Table 7 of the staff report, Mr. Geadah went on. Even with the reduction of the rate of growth of output called for under the current development plan and the adoption of adjustment measures, fiscal and balance of payments deficits were projected. Given the magnitude of the public sector's absorption of domestic and external resources, the adjustment effort should focus on strengthening the fiscal position.

Although the authorities had tightened fiscal policies in 1985, revenue had declined and current expenditures had increased as a proportion of GDP, Mr. Geadah noted. Furthermore, the fiscal deficit was projected to increase sharply in 1986 despite the measures proposed to reduce its originally budgeted amount. While the measures contemplated to broaden the tax base were welcome, a moderation in the growth of the size of government would not only reduce the growth in fiscal outlays, but might ease the labor shortage facing the manufacturing and tourism sectors. In addition to restraining the growth of current outlays, the authorities should also be cautious in their capital spending. In that context, an integration of the apparatus for the evaluation of projects financed by foreign sources with that for evaluating projects financed domestically should further help tighten control of such spending.

An improvement in the fiscal position should allow more room for noninflationary growth of the private sector, Mr. Geadah added. In 1985, limits on the growth of credit had resulted in a decline in credit to the private sector but an expansion in credit to the public sector of 32 percent. With respect to the system of monetary control, while the rationing of credit had contributed to the improvement of the external position, such direct controls could lead to a misallocation of resources. Therefore, he concurred with the staff on the desirability of substituting the system of credit rationing with indirect methods of control, such as the use of reserve requirement ratios. Externally, he had noted the progress achieved by the authorities in promoting exports, in the context of their exchange rate regime, and in the management of external debt. However, the growth of exports would be further encouraged by a unified exchange rate. As the staff had suggested, the recent reduction in import costs seemed to provide a convenient opportunity for such action. In sum, he agreed with the main points of the staff analysis and conclusions, and he supported the proposed decision.

Ms. Lundsager remarked that the staff reports and Mr. Finaish's statement provided a relatively favorable picture of developments in 1985. Economic growth had remained quite strong, the balance of payments had moved into a small overall surplus, total external debt had declined by a small amount, and the fiscal deficit had declined. The one less than welcome development was the acceleration of inflation. While those outcomes were for the most part quite gratifying, they masked some underlying trends that might be somewhat less favorable, as revealed by the projections for 1986, which indicated that some of the improvements generated in 1985 could well be reversed in the current year.

To be specific, the overall fiscal position was expected to deteriorate further as capital spending, which had declined in 1985, was budgeted to increase substantially, Ms. Lundsager observed. Of course, it might not be possible to implement all projects as planned, and thus the overall deficit might be considerably below the budgeted 11.7 percent of GDP, including foreign grants. However, with a substantial portion of the deficit being financed by domestic money creation--and broad money had grown by some 45 percent in 1985--it was difficult to expect inflation to remain low, even if real growth continued at around 10 percent.

The medium-term scenarios presented in the appendix to the staff report pointed quite clearly to the implications of continuing to aim for very high real growth targets, Ms. Lundsager observed. Column 2 of that appendix presented the sobering possibility of a high growth strategy, combined with no adjustment, and leading to total external debt of some 120 percent of GDP by 1990, with a current account deficit of some 33 percent of GDP. While the debt service ratio would remain below that of many countries, such a strategy most likely would not be sustainable beyond that point, opening up the possibility of a period of debt servicing difficulties and coerced domestic adjustment in the 1990s. A much more favorable outcome was presented in column 5, for moderate growth with adjustment measures, a strategy that could lead to permanently sustainable real economic growth beyond 1990, and to a permanent increase in real per capita incomes.

Suggested policy measures were put forward in the staff report, and Mr. Finaish had highlighted some planned fiscal actions that could result in a reduced fiscal deficit, below the budgeted level, and a more modest accumulation of external debt, Ms. Lundsager noted. She cautioned against a rapid expansion in the size of the civil service, which could lead to the need to sustain a large government in the long run simply to maintain employment levels. Instead, it might be useful to encourage the provision of more goods and services by the private sector, supported by higher and steadier increases in credit than in 1985. The tourism and fisheries sectors appeared to be thriving and to be generally suited to private sector developments. A more moderate government hiring policy could encourage labor to seek alternative employment in such sectors, thereby easing the tight labor market. Furthermore, the program of the authorities for rapid development had generated maintenance costs that required budgetary allocations. Perhaps more modest annual development goals, combined with adequate budgeting for recurrent expenditures, could ensure a more efficient use of national resources. Finally, a broader tax base and a rationalized tax system could strengthen the overall budgetary position. Supporting measures to strengthen the public enterprise sector, including perhaps some divestment where feasible, would be welcome.

Improvements in the management of monetary policy could assist in that process of strengthening the productive sectors, Ms. Lundsager considered. Specifically, the sectoral credit allocation system did not appear to have functioned smoothly, and it might be useful to adopt more generalized monetary policies that supported a more flexible allocation of resources.

With respect to the external sector, the movement in 1985 to a basket peg and the frequent adjustments in that peg were welcome, Ms. Lundsager remarked. Nonetheless, it appeared that some further adjustments in the exchange rate might be warranted, given the emergence of a parallel market in 1985 with margins of as much as 30-40 percent above the official rate in recent months. For an economy that was so dependent on imports, a strong export base must remain a priority, and appropriate exchange rates could provide support to the export sector. Furthermore, official reserves equal to about one month's imports seemed insufficient for a country so heavily dependent on imports.

The authorities had in general succeeded in developing their economy rapidly, supported in large part by concessional assistance from abroad, Ms. Lundsager noted, as indicated by the fact that while the overall debt to GDP ratio was fairly high, the debt servicing ratio was not. Nonetheless, she cautioned against the stimulation of continued rapid rates of growth supported by external debt financing.

The introduction in 1985 of a page for the Maldives in International Financial Statistics was welcome, Ms. Lundsager concluded. She supported the proposed decision.

Mr. Jayawardena, expressing broad agreement with the staff appraisal and support for the proposed decision, recalled that during the 1984 Article IV consultation discussion (EBM/85/10, 1/23/85), concern had been expressed in the Board about the adequacy of Maldives' adjustment to a difficult external environment. Fortunately, the authorities had paid heed to those concerns and had commenced a process of restructuring the economy. Of particular relevance to the Fund was the transition in July 1985 from the U.S. dollar peg of the rufiyaa to one related to a basket of the currencies of major trading partners that had yielded much needed flexibility to the authorities in managing their economy, a flexibility that was vital in a country which was 90 percent dependent on external trade.

The efficacy of the exchange rate as a key instrument of economic policy in the special circumstances of Maldives--for instance, inadequate transport and infrastructure among a large number of islands and atolls and the degree of monetization--was open to debate, Mr. Jayawardena remarked. But the limited domestic resource base and hence the need for outward-oriented development made him certain that flexibility of the price at which trade was conducted with the rest of the world would prove helpful to the authorities.

He complimented the authorities on having tightened fiscal policy in 1985, Mr. Jayawardena continued. By means of greater expenditure control, the mobilization of additional revenue, and the excision of lower priority capital projects, the fiscal deficit had been contained at 4.5 percent of GDP, substantially below the original expectation of a rise to 14 percent of GDP. However, the projected growth of the fiscal deficit in 1986 was of some concern, and he hoped that the remarkable turnabout achieved in 1985 could be repeated. Admittedly, part of the increase in the 1986 deficit reflected the availability of foreign grants and loans carried over from previous years when they had been unutilized due to structural bottlenecks. But part of the increase was also due to the expansion of current expenditures, which could be kept in check if a more selective policy in expanding public services was followed. Needless to say, investment in capital maintenance and social infrastructure would have to be safeguarded. He commended the authorities for agreeing to consider new revenue sources so as to diversify the tax base.

With respect to monetary policy, there had been a notable decline in domestic credit expansion--to 16 percent in 1985--and interest rates had remained highly positive in real terms, as measured by the GDP deflator, Mr. Jayawardena remarked. But it appeared that the Government's growing credit needs had had to be met, perhaps at the expense of the needs of the private sector. He considered that to be a short-term phenomenon since there had been delays in utilizing external assistance. Another interesting aspect had been the use of credit rationing in 1985, about which the staff and some Executive Directors appeared to have great misgivings. Yet in a country with 180,000 people, living mostly on a few islands, credit rationing could be a powerful instrument if used with great care; on the contrary, it could be argued that leakages might be widespread for the same reason. At the same time, in a country where a money market had yet to be fully developed, the question was how effective traditional market-related instruments would be. Whatever the situation in the Maldives, he hoped that selective credit controls would not turn out to be an instrument for preempting resources for use by the Government at nonmarket or unrealistic rates, because that could prove counterproductive.

He had been glad to note that the external position had improved in 1985, the current account declining to 12 percent of GDP, Mr. Jayawardena said. Exports had grown, imports had declined, and the surplus on the services account had risen sharply, the overall balance having shown a small surplus. However, the authorities would be the first to agree that the underlying balance of payments still remained weak and that external debt service, although low at present, could pose problems in the future. He had been greatly encouraged by the staff's simulation of alternative growth paths, which should prove invaluable to the authorities in shaping their future policies. Clearly, a high growth scenario did not appear to yield a viable external position, and the authorities might have to lower their sights. Such work by the staff helped countries to re-evaluate their policies, and also contributed to developing a good image of the Fund as a helpful and positive institution. He would be interested in any comment by the staff on the authorities' reactions to that simulation.

Summing up, Mr. Jayawardena said that his general impression of economic management in Maldives was that it was well informed and competent. It did not seem possible to fault a country that appeared to be coming out of the world recession with 10 percent economic growth, 5 percent inflation, virtually no unemployment, and perceptible development of economic and social infrastructure. But given the very limited resource and inadequate infrastructure, and hence the necessity for outward-oriented development, the tasks ahead of the authorities were formidable, and he recommended economic prudence while wishing them success.

The staff representative from the Asian Department observed that the authorities had expressed broad agreement with the medium-term scenarios depicted by the staff in the appendix to the staff report. They were aware that the high growth strategy without adjustment was the worst case scenario and that the need for adjustment was imperative. Therefore, they had introduced several measures in the 1986 budget and would endeavor to make a further adjustment in fiscal policy. When the Vice-Governor of the Maldives Monetary Authority had visited the Fund in February, he had expressed the hope that the Government could contain the budget deficit within the range of Rf 35-40 million, or somewhat less than the deficit of Rf 50 million mentioned when the staff had discussed fiscal policies with the authorities in Male.

On monetary policy, the staff representative noted that credit rationing measures had been adopted for a temporary period. The mission had discussed the implications of those measures, in particular, the resulting decline in credit to the private sector alongside heavy bank borrowing by the government sector and public enterprises. The authorities had recognized those implications and had assured the staff that they would be borne in mind in 1986 as they attempted to improve their monetary performance. They had expressed the wish to experiment with various ways of controlling the monetary aggregates.

Again, the Maldivian authorities realized that a further adjustment of the exchange rate was necessary, the staff representative from the Asian Department concluded. The impact of the exchange rate adjustment on prices would not be great in 1986 because of the decline in oil prices and the prices of other commodity imports as well. Therefore, he hoped that an active exchange rate policy would be continued.

Mr. Finaish said that he would convey the views of Executive Directors to the authorities of Maldives. The year 1985 had been much better than expected. For 1986 and beyond, the authorities were aware of the underlying weaknesses in the balance of payments. The economy was open, the resource base was very limited, and the future of the Maldives might be clouded by the changes in the oil price situation and the prospects of aid from oil exporting countries. Consequently, the authorities recognized that their development strategy had to be based on sustainable rates of growth and that adjustment in the fiscal, monetary, and external areas was therefore needed. Although the authorities might differ on the effectiveness of certain instruments, they were generally in broad agreement with the advice given by the staff in its appraisal. He had outlined in his opening statement some of the measures that had already been taken and some that were to be taken in the near future.

The Acting Chairman made the following summing up:

Executive Directors noted with commendation the strong performance of the economy in 1985, with continued rapid expansion in economic activity, a noticeable reduction in the fiscal deficit, and only moderate increases in prices. In addition, Directors remarked that the external payments position had improved markedly, the overall balance of payments having registered a small surplus for the first time in the 1980s and external debt service payments having eased somewhat. Directors commended the authorities for adopting a basket-peg arrangement and for more flexible use of exchange rate policy to help achieve competitiveness.

At the same time, Directors noted that Maldives continued to experience a tight labor market with a limited number of skilled local workers, and the economy continued to be heavily influenced by external developments. Despite the recent improvement in the balance of payments, the continuing structural weakness in the external payments position was likely to be aggravated unless the authorities' growth strategy was accompanied by decisive policy adjustments focused on tight financial policies, the easing of labor shortages, and also an active exchange rate policy.

Following the welcome reduction in the 1985 budget deficit, much concern was expressed about the sharp increase in the overall budget deficit envisaged by the authorities in 1986. It was stressed that that deficit should be reduced substantially by broadening the tax base, by economizing the Government's staffing requirements, and by being more selective in initiating externally financed development projects. Directors noted that efforts to control civil service employment would also help to relieve the already tight labor market. In addition, they stressed the need to reduce domestic bank financing of the budget deficit. More generally with respect to monetary policy, Directors encouraged the authorities to pursue a more restrained growth in credit and money. They mentioned that while the present system of credit rationing could help contain the growth of credit, it could lead to misallocation of financial resources. Therefore, Directors thought that the financial system needed to be made increasingly reliant on market forces through the use of more flexible interest rates and reserve requirements in order to promote a more efficient allocation of resources.

Directors commended the authorities for the recent progress in managing external debt but underscored the need for further progress in light of the medium-term external debt scenarios presented by the staff. Directors urged the authorities to pursue a realistic growth objective that took into account the availability of external financing and the need to maintain a sustainable external payments position. Directors encouraged the authorities to continue to pursue an active exchange rate policy and believed that the rate should be adjusted to a level that would eliminate the parallel market; such an adjustment, accompanied by appropriate tight financial policies, should strengthen the competitiveness of the external sector and increase the availability of foreign exchange.

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

The Executive Board then took the following decision:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Maldives, in the light of the 1985 Article IV consultation with Maldives concluded under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Maldives maintains an exchange system that is free of restriction on the making of payments and transfers for current international transactions.

Decision No. 8228-(86/47), adopted
March 19, 1986

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/46 (3/14/86) and EBM/86/47 (3/19/86).

3. SUDAN - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE S-1

1. The complaint of the Managing Director dated March 13, 1986 regarding Sudan's overdue obligation in the SDR Department, in EBS/86/62 (3/13/86) and Correction 1 (3/17/86), is noted. It shall be placed on the agenda of the Executive Board for April 16, 1986. If by that time Sudan has not become current in its obligation to pay charges in the SDR Department, the Fund will consider suspending the right of Sudan to use SDRs it acquires after the suspension pursuant to Article XXIII, Section 2(b).

2. The Fund urges Sudan to become current in its financial obligations to the Fund promptly and to avoid thereby the need for the Fund to take remedial action.

3. Consideration of the complaint in accordance with Rule S-1 particularly affects Sudan. The member shall be informed by rapid means of communication of this matter and of its right to present its views through an appropriately authorized representative.

Decision No. 8229-(86/47) S, adopted
March 18, 1986

4. INDIA - 1986 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted

April 29, 1977, the Executive Board agrees to extend the period for completing the 1986 Article IV consultation with India to not later than April 28, 1986. (EBD/86/69, 3/12/86)

Decision No. 8230-(86/47), adopted
March 14, 1986

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/60 (3/13/86) is approved.

APPROVED: November 25, 1986

LEO VAN HOUTVEN
Secretary